

RLI CORP  
Form 10-Q  
October 26, 2010

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended September 30, 2010**

or

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

**For the transition period from                      to**

**Commission File Number: 001-09463**

**RLI Corp.**

(Exact name of registrant as specified in its charter)

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**ILLINOIS**

(State or other jurisdiction of  
incorporation or organization)

**37-0889946**

(I.R.S. Employer  
Identification Number)

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

(Address of principal executive offices)

**61615**

(Zip Code)

**(309) 692-1000**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of October 15, 2010, the number of shares outstanding of the registrant's Common Stock was 20,947,794.

## 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 Ended September 30,	
	2010	2009
Net premiums earned	\$ 128,334	\$ 122,736
Net investment income	16,762	16,295
Net realized investment gains	4,527	6,985
Other-than-temporary impairment (OTTI) losses on investments		
Consolidated revenue	149,623	146,016
Losses and settlement expenses	55,823	47,677
Policy acquisition costs	40,624	41,627
Insurance operating expenses	10,161	10,480
Interest expense on debt	1,512	1,512
General corporate expenses	2,148	2,177
Total expenses	110,268	103,473
Equity in earnings of unconsolidated investee	1,648	1,120
Earnings before income taxes	41,003	43,663
Income tax expense	13,038	12,644
Net earnings	\$ 27,965	\$ 31,019
Other comprehensive earnings, net of tax	30,476	36,969
Comprehensive earnings	\$ 58,441	\$ 67,988
Earnings per share:		
Basic:		
Basic net earnings per share	\$ 1.34	\$ 1.43
Basic comprehensive earnings per share	\$ 2.79	\$ 3.14
Diluted:		
Diluted net earnings per share	\$ 1.33	\$ 1.42
Diluted comprehensive earnings per share	\$ 2.77	\$ 3.12
Weighted average number of common shares outstanding		
Basic	20,931	21,622
Diluted	21,090	21,769
Cash dividends declared per common share	\$ 0.29	\$ 0.27

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	For the Nine-Month Periods Ended September 30,	
	2010	2009
Net premiums earned	\$ 366,356	\$ 370,910
Net investment income	50,127	50,494
Net realized investment gains	15,281	24,442
Other-than-temporary impairment (OTTI) losses on investments		(45,231)
Consolidated revenue	431,764	400,615
Losses and settlement expenses	155,152	157,678
Policy acquisition costs	118,804	121,196
Insurance operating expenses	27,158	28,814
Interest expense on debt	4,537	4,537
General corporate expenses	5,406	5,847
Total expenses	311,057	318,072
Equity in earnings of unconsolidated investee	7,327	5,242
Earnings before income taxes	128,034	87,785
Income tax expense	40,854	24,502
Net earnings	\$ 87,180	\$ 63,283
Other comprehensive earnings, net of tax	27,986	63,357
Comprehensive earnings	\$ 115,166	\$ 126,640
Earnings per share:		
Basic:		
Basic net earnings per share	\$ 4.14	\$ 2.93
Basic comprehensive earnings per share	\$ 5.47	\$ 5.86
Diluted:		
Diluted net earnings per share	\$ 4.11	\$ 2.91
Diluted comprehensive earnings per share	\$ 5.42	\$ 5.82
Weighted average number of common shares outstanding		
Basic	21,043	21,599
Diluted	21,233	21,759
Cash dividends declared per common share	\$ 0.86	\$ 0.80

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

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RLI Corp. and Subsidiaries Condensed Consolidated Balance Sheets

(in thousands, except share data)	September 30, 2010 (unaudited)	December 31, 2009
<b>ASSETS</b>		
Investments		
Fixed income		
Available-for-sale, at fair value	\$ 1,264,862	\$ 1,273,518
Held-to-maturity, at amortized cost	278,891	210,888
Trading, at fair value	16	941
Equity securities, at fair value	301,594	262,693
Short-term investments, at cost	133,018	104,462
Total investments	1,978,381	1,852,502
Accrued investment income	13,488	16,845
Premiums and reinsurance balances receivable	99,703	83,961
Ceded unearned premium	61,037	65,379
Reinsurance balances recoverable on unpaid losses	337,304	336,392
Deferred policy acquisition costs	77,766	75,880
Property and equipment	18,097	19,110
Investment in unconsolidated investees	51,154	44,286
Goodwill	26,214	26,214
Other assets	10,431	18,084
<b>TOTAL ASSETS</b>	<b>\$ 2,673,575</b>	<b>\$ 2,538,653</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Unpaid losses and settlement expenses	\$ 1,170,246	\$ 1,146,460
Unearned premiums	319,301	312,527
Reinsurance balances payable	22,432	22,431
Income taxes-deferred	41,277	24,299
Bonds payable, long-term debt	100,000	100,000
Accrued expenses	32,912	41,835
Other liabilities	75,234	58,851
<b>TOTAL LIABILITIES</b>	<b>\$ 1,761,402</b>	<b>\$ 1,706,403</b>
Shareholders Equity		
Common stock (\$1 par value)		
(32,300,945 shares issued at 9/30/10)		
(32,179,091 shares issued at 12/31/09)	32,301	32,179
Paid-in capital	213,931	207,386
Accumulated other comprehensive earnings	105,397	77,411
Retained earnings	946,919	877,791
Deferred compensation	6,421	7,989
Less: Treasury shares at cost		
(11,353,151 shares at 9/30/10)		
(10,914,368 shares at 12/31/09)	(392,796)	(370,506)
<b>TOTAL SHAREHOLDERS EQUITY</b>	<b>912,173</b>	<b>832,250</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 2,673,575</b>	<b>\$ 2,538,653</b>

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





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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)	For the Nine-Month Periods Ended September 30,	
	2010	2009
Net cash provided by operating activities	\$ 87,867	\$ 108,445
Cash Flows from Investing Activities		
Investments purchased	(774,532)	(776,811)
Investments sold	218,083	334,386
Investments called or matured	512,650	353,230
Net change in short-term investments	(7,648)	(11,695)
Net property and equipment purchased	(1,297)	(507)
Net cash used in investing activities	\$ (52,744)	\$ (101,397)
Cash Flows from Financing Activities		
Cash dividends paid	\$ (17,932)	\$ (16,494)
Stock option plan share issuance	4,152	3,441
Excess tax benefit from exercise of stock options	2,515	257
Treasury shares reissued		5,748
Treasury shares purchased	(23,858)	
Net cash used in financing activities	\$ (35,123)	\$ (7,048)
Net increase in cash		
Cash at the beginning of the period		
Cash at September 30	\$	\$

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

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

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**A. BASIS OF PRESENTATION**

The unaudited condensed consolidated interim financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 2009 Annual Report on Form 10-K. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position at September 30, 2010 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 from these estimates.

**B. ADOPTED ACCOUNTING STANDARDS**

*ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*

This Accounting Standards Update (ASU) amends certain disclosure requirements of Subtopic 820-10. This ASU requires additional disclosures for the transfer of financial instruments in and out of Levels 1 and 2 and for activity in Level 3. This ASU also clarifies certain other existing disclosure requirements including level of desegregation and disclosures around inputs and valuation techniques. We adopted ASU 2010-06 on January 1, 2010 and applicable disclosures are included in note 3 to the condensed consolidated interim financial statements.

**C. PROSPECTIVE ACCOUNTING STANDARDS**

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

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Accounting guidance for deferred acquisition costs incurred by insurance entities changed under the ASU which eliminates inconsistent industry practices. The ASU requires costs to be incrementally or directly related to the successful acquisition of new or renewal insurance contracts in order to be capitalized as deferred acquisition costs.

Deferred acquisition costs will include agent and broker commissions, salaries

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of certain employees involved in underwriting and policy issuance, and medical and inspection fees. Previous accounting guidance described deferred acquisition costs as those that vary with and are primarily related to the acquisition of new and renewal insurance contracts. This resulted in some entities deferring only direct and incremental costs while others included certain indirect costs. Others deferred costs for all acquisition efforts, including rejected contracts.

The new guidance limits the capitalization of contract acquisition costs to these four components:

- Incremental direct costs of contract acquisition, primarily commissions, incurred in successful contracts;
- The portion of the employee's fixed compensation and payroll-related fringe benefits directly related to time spent performing any of the following acquisition activities for a contract that has been acquired:
  - Underwriting,
  - Policy issuance and processing,
  - Medical and inspection, and
  - Sales force contract selling;
- Other direct costs related to insurers' activities that would not have been incurred without the contract such as travel costs and itemized long-distance telephone calls incurred with acquisition activities; and
- Advertising costs that meet the direct response advertising capitalization criteria.

Entities will not be required to capitalize costs that they had previously expensed as a result of applying the new guidance.

The effective date for the guidance will be interim and annual periods beginning after December 15, 2011. Early adoption is permitted but only at the beginning of an entity's annual reporting period.

Either prospective or retrospective application is permitted. If applied on a retrospective basis, the guidance does not require the disclosure of the effect of the change in accounting principle in the current period. However, if the prospective basis is applied, entities will be required to disclose either the effect of the change in the period of adoption or its effect in the period immediately preceding adoption.

We have not assessed the impact of adopting the ASU on our financial statements.

### D. INTANGIBLE ASSETS

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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, which relates to our surety segment, is listed separately on the balance sheet and totaled \$26.2 million at September 30, 2010 and December 31, 2009. Annual impairment testing was performed during the second quarter of 2010. Based upon this

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review, this asset was not impaired. In addition, as of September 30, 2010, there were no triggering events that had occurred that would suggest an updated review was necessary.

E. EARNINGS PER SHARE

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

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

(in thousands, except per share data)	For the Three-Month Period Ended September 30, 2010			For the Three-Month Period Ended September 30, 2009		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic EPS</b>						
Income available to common shareholders	\$ 27,965	20,931	\$ 1.34	\$ 31,019	21,622	\$ 1.43
<b>Effect of Dilutive Securities</b>						
Stock Options		159			147	
<b>Diluted EPS</b>						
Income available to common shareholders	\$ 27,965	21,090	\$ 1.33	\$ 31,019	21,769	\$ 1.42

(in thousands, except per share data)	For the Nine-Month Period Ended September 30, 2010			For the Nine-Month Period Ended September 30, 2009		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic EPS</b>						
Income available to common shareholders	\$ 87,180	21,043	\$ 4.14	\$ 63,283	21,599	\$ 2.93
<b>Effect of Dilutive Securities</b>						
Stock options		190			160	
<b>Diluted EPS</b>						
Income available to common shareholders	\$ 87,180	21,233	\$ 4.11	\$ 63,283	21,759	\$ 2.91



**2. INVESTMENTS**

Our investments include fixed income debt securities and common stock equity securities. As disclosed in our 2009 Annual Report on Form 10-K, we present our investments in these classes as either available-for-sale, held-to-maturity, or trading securities. When available, we obtain quoted market prices to determine fair value for our investments. If a quoted market price is not available, fair value is estimated using a secondary pricing source or using quoted market prices of similar securities. We have no investment securities for which fair value is determined using Level 3 inputs as defined in note 3 to the unaudited condensed consolidated interim financial statements, Fair Value Measurements.

We conduct and document periodic reviews of all securities with unrealized losses to evaluate whether the impairment is other-than-temporary. The following tables are used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of September 30, 2010 and December 31, 2009. The tables segregate the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position. As of September 30, 2010 and December 31, 2009, unrealized losses, as shown in the following tables, were less than 1% of total invested assets. Unrealized losses have decreased in 2010, as the capital markets have strengthened in 2010.



## Investment Positions with Unrealized Losses

## Segmented by Type and Period of Continuous

## Unrealized Loss at September 30, 2010

(dollars in thousands)	< 12 Mos.	12 Mos. & Greater	Total
<b>U.S Government</b>			
Fair value	\$	\$	\$
Cost or Amortized Cost			
Unrealized Loss			
<b>U.S Agency</b>			
Fair value	\$ 44,336	\$	\$ 44,336
Cost or Amortized Cost	44,525		44,525
Unrealized Loss	(189)		(189)
<b>Mortgage-backed</b>			
Fair value	\$ 32,189	\$	\$ 32,189
Cost or Amortized Cost	32,400		32,400
Unrealized Loss	(211)		(211)
<b>ABS/CMO*</b>			
Fair value	\$	\$	\$
Cost or Amortized Cost			
Unrealized Loss			
<b>Corporate</b>			
Fair value	\$ 13,959	\$ 509	\$ 14,468
Cost or Amortized Cost	14,106	515	14,621
Unrealized Loss	(147)	(6)	(153)
<b>States, political subdivisions &amp; revenues</b>			
Fair value	\$ 7,606	\$ 1,042	\$ 8,648
Cost or Amortized Cost	7,640	1,052	8,692
Unrealized Loss	(34)	(10)	(44)
<b>Subtotal, debt securities</b>			
Fair value	\$ 98,090	\$ 1,551	\$ 99,641
Cost or Amortized Cost	98,671	1,567	100,238
Unrealized Loss	(581)	(16)	(597)
<b>Common Stock</b>			
Fair value	\$ 26,563	\$ 2,204	\$ 28,767
Cost or Amortized Cost	27,882	2,479	30,361
Unrealized Loss	(1,319)	(275)	(1,594)
<b>Total</b>			
Fair value	\$ 124,653	\$ 3,755	\$ 128,408
Cost or Amortized Cost	126,553	4,046	130,599
Unrealized Loss	(1,900)	(291)	(2,191)

\* Asset-backed & collateralized mortgage obligations.

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

## Investment Positions with Unrealized Losses

## Segmented by Type and Period of Continuous

## Unrealized Loss at December 31, 2009

(dollars in thousands)	< 12 Mos.	12 Mos. & Greater	Total
<b>U.S Government</b>			
Fair value	\$	\$	\$
Cost or Amortized Cost			
Unrealized Loss			
<b>Non-U.S Government</b>			
Fair value	\$ 934	\$	\$ 934
Cost or Amortized Cost	945		945
Unrealized Loss	(11)		(11)
<b>U.S Agency</b>			
Fair value	\$ 248,507	\$	\$ 248,507
Cost or Amortized Cost	253,027		253,027
Unrealized Loss	(4,520)		(4,520)
<b>Mortgage-backed</b>			
Fair value	\$ 24,931	\$	\$ 24,931
Cost or Amortized Cost	25,302		25,302
Unrealized Loss	(371)		(371)
<b>ABS/CMO *</b>			
Fair value	\$ 4,587	\$ 3,255	\$ 7,842
Cost or Amortized Cost	4,640	3,331	7,971
Unrealized Loss	(53)	(76)	(129)
<b>Corporate</b>			
Fair value	\$ 68,436	\$ 8,420	\$ 76,856
Cost or Amortized Cost	69,541	8,969	78,510
Unrealized Loss	(1,105)	(549)	(1,654)
<b>States, political subdivisions &amp; revenues</b>			
Fair value	\$ 72,922	\$ 7,028	\$ 79,950
Cost or Amortized Cost	73,531	7,174	80,705
Unrealized Loss	(609)	(146)	(755)
<b>Subtotal, debt securities</b>			
Fair value	\$ 420,317	\$ 18,703	\$ 439,020
Cost or Amortized Cost	426,986	19,474	446,460
Unrealized Loss	(6,669)	(771)	(7,440)
<b>Common Stock</b>			
Fair value	\$ 11,720	\$ 2,468	\$ 14,188
Cost or Amortized Cost	12,019	2,624	14,643
Unrealized Loss	(299)	(156)	(455)
<b>Total</b>			
Fair value	\$ 432,037	\$ 21,171	\$ 453,208
Cost or Amortized Cost	439,005	22,098	461,103

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Unrealized Loss	(6,968)	(927)	(7,895)
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\* Asset-backed & collateralized mortgage obligations.

This table excludes securities with a fair value of \$0.9 million, classified as trading.

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

### *Available-for-Sale Securities*

The amortized cost and fair value of securities available-for-sale at September 30, 2010 and December 31, 2009 were as follows:

#### **Available-for-sale**

(in thousands)

Asset Class	9/30/2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Agencies	\$ 107,769	\$ 1,621	\$ (4)	\$ 109,386
Corporates	537,391	48,678	(53)	586,016
Mortgage-backed	253,422	12,730	(211)	265,941
ABS/CMO*	46,533	3,124		49,657
Treasuries	10,891	418		11,309
Munis	231,595	11,002	(44)	242,553
<b>Total Fixed Income</b>	<b>\$ 1,187,601</b>	<b>\$ 77,573</b>	<b>\$ (312)</b>	<b>\$ 1,264,862</b>

#### **Available-for-sale**

(in thousands)

Asset Class	12/31/2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Agencies	\$ 135,554	\$ 850	\$ (1,572)	\$ 134,832
Corporates	423,042	16,901	(1,654)	438,289
Mortgage-backed	234,936	7,019	(371)	241,584
ABS/CMO*	48,722	1,567	(129)	50,160
Treasuries**	6,384	243	(11)	6,616
Munis	391,565	11,227	(755)	402,037
<b>Total Fixed Income</b>	<b>\$ 1,240,203</b>	<b>\$ 37,807</b>	<b>\$ (4,492)</b>	<b>\$ 1,273,518</b>

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\*Asset-backed and collateralized mortgage obligations

\*\* Includes U.S. and Non-U.S. Government treasuries in 2009



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The following table presents the amortized cost and fair value of available-for-sale debt securities by contractual maturity dates as of September 30, 2010, and December 31, 2009:

AFS (in thousands)	9/30/2010		12/31/2009	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<b>Agencies</b>				
Due within 1 year	\$ 3,009	\$ 3,062	\$ 1,000	\$ 1,045
After 1 but within 5 years	4,818	5,101	21,336	21,483
After 5 but within 10 years	53,978	54,282	34,487	34,168
After 10 years*	45,964	46,941	78,731	78,136
Total	107,769	109,386	135,554	134,832
<b>Corporates</b>				
Due within 1 year	\$ 23,861	\$ 25,544	\$ 10,510	\$ 10,594
After 1 but within 5 years	168,310	185,268	126,627	133,032
After 5 but within 10 years	318,542	345,546	272,995	281,814
After 10 years	26,678	29,658	12,910	12,849
Total	537,391	586,016	423,042	438,289
<b>Mortgage-backed</b>				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years	5,112	5,409	6,535	6,819
After 10 years*	248,310	260,532	228,401	234,765
Total	253,422	265,941	234,936	241,584
<b>Asset-backed</b>				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years	4,398	4,600	3,148	3,285
After 5 but within 10 years	5,575	6,308	8,704	9,360
After 10 years*	36,560	38,749	36,870	37,515
Total	46,533	49,657	48,722	50,160
<b>Treasuries</b>				
Due within 1 year	\$ 3,876	\$ 3,962	\$	\$
After 1 but within 5 years	7,015	7,347	6,384	6,616
After 5 but within 10 years				
After 10 years*				
Total	10,891	11,309	6,384	6,616
<b>Munis</b>				
Due within 1 year	\$ 17,555	\$ 17,757	\$ 12,079	\$ 12,299
After 1 but within 5 years	25,988	27,277	80,052	84,470
After 5 but within 10 years	82,600	87,129	122,497	126,056
After 10 years*	105,452	110,390	176,937	179,212
Total	231,595	242,553	391,565	402,037
<b>TOTAL</b>	<b>\$ 1,187,601</b>	<b>\$ 1,264,862</b>	<b>\$ 1,240,203</b>	<b>\$ 1,273,518</b>

\* Investments with no stated maturities are included as contractual maturities of greater than 10 years. Actual maturities may differ due to call or prepayment rights.





*Held-to-Maturity Debt Securities*

The carrying value and fair value of held-to-maturity securities at September 30, 2010 and December 31, 2009 were as follows:

**Held-to-maturity**

(in thousands)

Asset Class	Amortized Cost/ Carrying Value**	9/30/2010		Fair Value
		Gross Unrecognized Gains	Gross Unrecognized Losses	
Agencies	\$ 256,820	\$ 1,961	\$ (185)	\$ 258,596
Corporates	15,000		(100)	14,900
Mortgage-backed ABS/CMO*				
Treasuries				
Munis	7,071	284		7,355
<b>Total Fixed Income</b>	<b>\$ 278,891</b>	<b>\$ 2,245</b>	<b>\$ (285)</b>	<b>\$ 280,851</b>

**Held-to-maturity**

(in thousands)

Asset Class	Amortized Cost/ Carrying Value**	12/31/2009		Fair Value
		Gross Unrecognized Gains	Gross Unrecognized Losses	
Agencies	\$ 200,064	\$ 732	\$ (2,948)	\$ 197,848
Corporates				
Mortgage-backed ABS/CMO*				
Treasuries				
Munis	10,824	347		11,171
<b>Total Fixed Income</b>	<b>\$ 210,888</b>	<b>\$ 1,079</b>	<b>\$ (2,948)</b>	<b>\$ 209,019</b>

\*Asset-backed and collateralized mortgage obligations

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



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The following table presents the carrying value and fair value of debt securities held-to-maturity by contractual maturity dates as of September 30, 2010 and December 31, 2009:

HTM (in thousands)	9/30/2010		12/31/2009	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<b>Agencies</b>				
Due within 1 year	\$ 4,079	\$ 4,178	\$	\$
After 1 but within 5 years	3,956	4,404	16,669	17,374
After 5 but within 10 years	44,971	45,220	109,975	108,798
After 10 years*	203,814	204,794	73,420	71,676
Total	256,820	258,596	200,064	197,848
<b>Corporates</b>				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years	15,000	14,900		
Total	15,000	14,900		
<b>Mortgage-backed</b>				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years*				
Total				
<b>Asset-backed</b>				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years*				
Total				
<b>Treasuries</b>				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years*				
Total				
<b>Munis</b>				
Due within 1 year	\$	\$	\$ 2,220	\$ 2,223
After 1 but within 5 years	7,071	7,355	7,950	8,178
After 5 but within 10 years			654	770
After 10 years*				
Total	7,071	7,355	10,824	11,171
<b>TOTAL</b>	<b>\$ 278,891</b>	<b>\$ 280,851</b>	<b>\$ 210,888</b>	<b>\$ 209,019</b>

\*Investments with no stated maturities are included as contractual maturities of greater than 10 years. Actual maturities may differ due to call or prepayment rights.



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The following table shows the composition of the fixed income securities in unrealized loss positions at September 30, 2010 by the National Association of Insurance Commissioners (NAIC) rating and the generally equivalent Standard & Poor's (S&P) and Moody's ratings. The vast majority of the securities are rated by S&P and/or Moody's.

NAIC Rating	Equivalent S&P Rating	Equivalent Moody's Rating	(dollars in thousands)			Percent to Total
			Book Value	Fair Value	Unrealized Loss	
1	AAA/AA/A	Aaa/Aa/A	\$ 98,136	\$ 97,560	\$ (576)	96.5%
2	BBB	Baa	2,102	2,081	(21)	3.5%
3	BB	Ba				
4	B	B				
5	CCC or lower	Caa or lower				
6						
		Total	\$ 100,238	\$ 99,641	\$ (597)	100.0%

The fixed income portfolio contained 25 unrealized loss positions as of September 30, 2010. The \$0.6 million in associated unrealized losses for these 25 securities represents less than 0.1% of the fixed income portfolio's cost basis. Of these 25 securities, two have been in an unrealized loss position for 12 consecutive months or longer and these collectively represent less than \$0.1 million in unrealized losses. The unrealized losses on these two securities are due to changes in interest rates, and are not credit-specific issues. We continue to receive all contractual payments as agreed. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. In 2009, we adopted GAAP guidance on the recognition and presentation of other-than-temporary impairment (OTTI). Accordingly, 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 a high credit quality and we believe we will recover the amortized cost basis of our fixed income securities. The fixed income unrealized losses can primarily be attributed to changes in interest rates. 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 OTTI losses recognized in other comprehensive earnings in the periods presented.

We did not incur any OTTI charges on fixed income securities during the first three quarters of 2010. Comparatively, we recognized \$4.5 million of OTTI losses on fixed income securities during the first nine months of 2009. For the third quarter, there were no fixed income OTTI losses recognized during 2010 or 2009.

### *Evaluating Investments for OTTI*

We conduct periodic reviews to identify and evaluate each investment that has an unrealized loss. An unrealized loss exists when the current fair value of a security is less than its amortized cost. Regardless of the classification of securities as available-for-sale or held-to-maturity, we assess each position for impairment.

Factors that we consider in the evaluation of credit quality include:

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

As of September 30, 2010, we held 11 common stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled \$1.6 million. Based on our analysis, we believe these securities will recover in a reasonable period of time and we have the ability to hold these securities until recovery. Of the 11 common stock positions that were in an unrealized loss position, one has been in an unrealized loss position for 12 consecutive months or longer. This security represents \$0.3 million in unrealized losses. One equity security has been in an unrealized loss position for 12 months or more. This security is a biotech/medical company with a strong balance sheet and credit rating, and has been consistently profitable. Based on the volatility of the markets and our fundamental analysis of the firm, we do not believe this security meets our OTTI policy and we have the ability and intent to hold until recovery.

As part of our evaluation of the securities in an unrealized loss position and the potential for recovery in a reasonable period of time, we specifically review equity securities with unrealized losses as to the financial condition and future prospects of the issuers including valuation metrics, earnings strength and other relevant matters. In addition, we monitor the price volatility of the equity securities themselves. Securities for which we have the ability and intent to hold at least until the investment impairment is recovered given the future prospects of the issuers, and securities with any unrealized losses due primarily to temporary market and/or sector-related factors other than issuer specific factors, are generally not considered other-than-temporarily impaired.

Through September 30, 2010, there were no impairment charges for equity securities. Comparatively, we recognized \$40.7 million of OTTI losses on equity securities during the first nine months of 2009. For the third quarter, there were no equity OTTI losses recognized during 2010 or 2009.

### **3. FAIR VALUE MEASUREMENTS**

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

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

We determined the fair values of certain financial instruments based on the fair value hierarchy. GAAP guidance requires an entity to maximize the use of

observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value.

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. Financial assets are classified based upon the lowest level of significant input that is used to determine fair value.

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. As a part of management's process to determine fair value, we utilize widely recognized, third party pricing sources to determine our fair values.

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

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



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**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.

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

(\$ in 000s) Description	As of September 30, 2010 Fair Value Measurements Using			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Trading securities				
Mortgage-backed	\$	\$ 16	\$	\$ 16
ABS/CMO*				
Treasuries				
Total trading securities	\$	\$ 16	\$	\$ 16
Available-for-sale securities				
Agencies	\$	\$ 109,386	\$	\$ 109,386
Corporates		586,016		586,016
Mortgage-backed		265,941		265,941
ABS/CMO*		49,657		49,657
Treasuries		11,309		11,309
Municipals		242,553		242,553
Equity	301,594			301,594
Total available-for-sale securities	\$ 301,594	\$ 1,264,862	\$	\$ 1,566,456
Total	\$ 301,594	\$ 1,264,878	\$	\$ 1,566,472

\*Asset-backed & collateralized mortgage obligations

(\$ in 000s) Description	As of December 31, 2009			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
<b>Trading securities</b>				
Corporate	\$	\$	102	\$
Mortgage-backed			18	
ABS/CMO*			674	
Treasuries			147	
Total trading securities	\$	\$	941	\$
<b>Available-for-sale securities</b>				
Agencies	\$	\$	134,832	\$
Corporates			438,289	
Mortgage-backed			241,584	
ABS/CMO*			50,160	
Treasuries**			6,616	
Municipals			402,037	
Equity		262,693		
Total available-for-sale securities	\$	262,693	\$	\$
			1,273,518	
Total	\$	262,693	\$	\$
			1,274,459	
				\$
				1,537,152

\*Asset-backed & collateralized mortgage obligations

\*\*Includes U.S. and Non-U.S. Government treasuries in 2009

As noted in the above table, we do not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period. Additionally, there were no securities transferred in or out of levels 1 or 2.

#### 4. STOCK BASED COMPENSATION

During 2005, our shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). The omnibus plan provided for grants of up to 1,500,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we have granted 1,225,200 stock options under this plan, including 16,100 in the first quarter of 2010.

During the second quarter of 2010, our shareholders approved the RLI Corp. Long-Term Incentive Plan (LTIP), which replaces the omnibus plan and which was filed with the Securities and Exchange Commission via a Form 8-K Current Report on May 6, 2010. In conjunction with the adoption of this plan, effective May 6, 2010, options will no longer be granted under the omnibus plan. The purpose of the LTIP is to promote our interests and those of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a high level of corporate performance and to encourage our continued success and growth. In addition, the opportunity to acquire a proprietary interest in the company will aid in attracting and retaining key personnel of outstanding ability. Awards under the LTIP may be in the form of restricted stock, stock options (nonqualified only), stock appreciation rights, performance units, as well as other stock based awards. Eligibility under the LTIP is limited to employees



or directors of the company or any affiliate. The granting of awards under the LTIP is solely at the discretion of the executive resources committee of the board of directors. The total number of shares of common stock available for distribution under the LTIP may not exceed 2,000,000 shares (subject to adjustment for changes in our capitalization). Thus far in 2010, we have granted 187,100 stock options under the LTIP.

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

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

The following tables summarize option activity for the periods ended September 30, 2010 and 2009:

	<b>Number of Options Outstanding</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life</b>	<b>Aggregate Intrinsic Value (in 000 s)</b>
Outstanding options at January 1, 2010	1,583,803	\$ 44.73		
Options granted	203,200	\$ 55.95		
Options exercised	(218,645)	\$ 32.91		\$ 4,914
Options canceled/forfeited	(42,864)	\$ 46.78		
Outstanding options at September 30, 2010	1,525,494	\$ 47.87	5.97	\$ 13,353
Exercisable options at September 30, 2010	841,473	\$ 44.30	5.02	\$ 10,370

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	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2009	1,429,128	\$ 43.35		
Options granted	244,900	\$ 47.84		
Options exercised	(58,815)	\$ 28.94		\$ 1,403
Options canceled/forfeited	(20,030)	\$ 51.96		
Outstanding options at September 30, 2009	1,595,183	\$ 44.46	6.17	\$ 13,271
Exercisable options at September 30, 2009	923,252	\$ 39.76	4.94	\$ 12,022

The majority of our options are granted annually at our regular board meeting in May. Thus far in 2010, 203,200 options were granted with an average exercise price of \$55.95 and an average fair value of \$13.37. We recognized \$0.7 million of expense in the third quarter of 2010, and \$2.3 million in the first nine months of 2010, related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.2 million in the third quarter of 2010, and \$0.8 million in the first nine months of 2010, 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 third quarter of 2009, and \$2.1 million in the first nine months of 2009. We recorded a tax benefit of \$0.3 million in the third quarter of 2009, and \$0.8 million in the first nine months of 2009, related to this compensation expense.

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

	2010	2009
Weighted-average fair value of grants	\$ 13.37	\$ 11.28
Risk-free interest rates	2.68%	2.06%
Dividend yield	1.74%	1.56%
Expected volatility	25.91%	26.20%
Expected option life	5.57 years	5.71 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. The expected volatility is calculated based on the mean reversion of RLI's stock. Prior to the second quarter of 2009, it was calculated by computing the weighted average of the most recent one-year volatility, the most recent volatility based on expected life and the median of the rolling volatilities based on the expected life of RLI stock. The expected option life is determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant.

**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 Ended September 30, REVENUES		For the Nine-Month Periods Ended September 30, REVENUES	
	2010	2009	2010	2009
Casualty	\$ 57,491	\$ 64,794	\$ 174,934	\$ 202,766
Property	50,167	39,829	132,133	115,394
Surety	20,676	18,113	59,289	52,750
Net premiums earned	\$ 128,334	\$ 122,736	\$ 366,356	\$ 370,910
Net investment income	16,762	16,295	50,127	50,494
Net realized gains (losses)	4,527	6,985	15,281	(20,789)
Total consolidated revenue	\$ 149,623	\$ 146,016	\$ 431,764	\$ 400,615
	NET EARNINGS		NET EARNINGS	
	2010	2009	2010	2009
Casualty	\$ 8,906	\$ 17,330	\$ 23,691	\$ 37,380
Property	5,288	3,914	22,669	19,271
Surety	7,532	1,708	18,882	6,571
Net Underwriting Income	\$ 21,726	\$ 22,952	\$ 65,242	\$ 63,222
Net investment income	16,762	16,295	50,127	50,494
Net realized gains (losses)	4,527	6,985	15,281	(20,789)
General corporate expense and interest on debt	(3,660)	(3,689)	(9,943)	(10,384)
Equity in earnings of unconsolidated investee	1,648	1,120	7,327	5,242
Total earnings before income taxes	\$ 41,003	\$ 43,663	\$ 128,034	\$ 87,785
Income tax expense	13,038	12,644	40,854	24,502
Total net earnings	\$ 27,965	\$ 31,019	\$ 87,180	\$ 63,283

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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 Ended September 30,		For the Nine-Month Periods Ended September 30,	
	2010	2009	2010	2009
<b>Casualty</b>				
General liability	\$ 23,874	\$ 28,533	\$ 73,653	\$ 88,353
Commercial and personal umbrella	15,361	15,474	45,855	47,131
Commercial transportation	10,088	10,264	30,871	31,732
Executive coverages	4,015	3,956	11,752	17,217
Specialty programs	1,604	4,533	5,717	11,433
Other	2,549	2,034	7,086	6,900
<b>Total</b>	<b>\$ 57,491</b>	<b>\$ 64,794</b>	<b>\$ 174,934</b>	<b>\$ 202,766</b>
<b>Property</b>				
Commercial property	\$ 20,122	\$ 20,915	\$ 60,284	\$ 61,482
Marine	11,891	12,880	35,119	39,101
Crop reinsurance	11,478		17,478	
Facultative reinsurance	2,386	2,324	7,764	5,286
Other property	4,290	3,710	11,488	9,525
<b>Total</b>	<b>\$ 50,167</b>	<b>\$ 39,829</b>	<b>\$ 132,133</b>	<b>\$ 115,394</b>
<b>Surety</b>	<b>\$ 20,676</b>	<b>\$ 18,113</b>	<b>\$ 59,289</b>	<b>\$ 52,750</b>
<b>Grand Total</b>	<b>\$ 128,334</b>	<b>\$ 122,736</b>	<b>\$ 366,356</b>	<b>\$ 370,910</b>

A detailed discussion of earnings and results by segment is contained in management's discussion and analysis of financial condition and results of operations.

### 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, 2009.

### OVERVIEW

We underwrite selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group (the Group). We conduct operations principally through three insurance companies. RLI Insurance Company, our principal subsidiary, writes multiple lines of insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company, a subsidiary of RLI Insurance Company, writes





surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company (RIC), a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines of insurance on an admitted basis in 48 states and the District of Columbia. RIC has authority to write fidelity and surety in North Carolina. We are an Illinois corporation that was organized in 1965. We have no material foreign operations.

As a niche company, we offer specialty insurance coverages designed to meet specific insurance needs of targeted insured groups and underwrite particular types of coverage for certain markets that are underserved by the insurance industry, such as our difference in conditions coverages or oil and gas surety bonds. We also provide types of coverages not generally offered by other companies, such as our stand-alone personal umbrella policy. The excess and surplus market, which unlike the standard admitted market is less regulated and more flexible in terms of policy forms and premium rates, provides an alternative for customers with hard-to-place risks. When we underwrite within the surplus lines market, we are selective in the line of business and type of risks we choose to write. Using our non-admitted status in this market allows us to tailor terms and conditions to manage these exposures more effectively than our admitted counterparts. Often the development of these specialty insurance coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients. Once a proposal is submitted, underwriters determine whether it would be a viable product in keeping with our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all marketplaces. 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. Regular 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). Private equity investments, primarily our minority ownership in Maui Jim, Inc. (Maui Jim), have also enhanced overall returns. We have a diversified investment portfolio and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite fluctuations of realized and unrealized gains and losses in the equity portfolio, our investment in equity securities as part of a long-term asset allocation strategy has contributed significantly to our historic growth in book value.

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

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

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

The casualty portion of our business consists largely of general liability, personal umbrella, transportation, executive products, commercial umbrella, multi-peril program business, and other specialty coverage, such as our professional liability for architects and engineers. In addition, we provide employers' indemnity and in-home business owners' coverage. 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 primarily includes commercial fire, earthquake, difference in conditions, marine, facultative reinsurance, and, in the state of Hawaii, select personal lines policies. Property insurance 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 Coasts, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by limiting the total policy limits written in a particular region, by purchasing reinsurance, and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

In 2010, we added crop reinsurance to the property segment as we entered into a two-year agreement to become a quota share reinsurer of Producers Agricultural Insurance Company (ProAg). ProAg is a crop insurance company located in Amarillo, Texas. Under this agreement, we will reinsure a portion of ProAg's multi-peril crop insurance (MPCI) and crop hail premium and exposure. Crop insurance is purchased by agricultural producers for protection against crop-related losses due to natural disasters and other perils. The MPCI program is a partnership with the U.S. Department of Agriculture (USDA). Crop insurers such as ProAg also issue policies that cover revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects, and disease. Generally,

policies have deductibles ranging from 10 percent to 50 percent of the insured's risk. The USDA's Risk Management Agency sets the policy terms and conditions, rates and forms for crop insurance products, and is also responsible for setting compliance standards. Our crop reinsurance business has inherent risks including a higher degree of estimation during interim periods, and a lag in reporting data from the insurer. We also rely more on the historical experience of the insurer in our estimation process.

The surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. We offer miscellaneous bonds, including license and permit, notary, and court bonds. We also offer fidelity and crime coverage for commercial insureds and select financial institutions. Often, our surety coverages involve a statutory requirement for bonds. While these bonds have maintained a relatively low loss ratio, losses may fluctuate due to adverse economic conditions that may affect the financial viability of an insured. The contract surety marketplace guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic conditions or the deterioration of a contractor's financial condition. As such, this line has historically produced marginally higher loss ratios than other surety lines.

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

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

Throughout this quarterly report, we present our operations in the way we believe will be most meaningful, useful, and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP presentation of net income and certain statutory reporting information, we show certain non-GAAP financial measures that we believe are valuable in managing our business and drawing comparisons to our peers. These measures are underwriting income, gross premiums written, net premiums written, 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 premium 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 5 to the unaudited condensed consolidated interim financial statements, 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.

*Gross premiums written*

While net premiums earned is the related GAAP measure used in the statements of earnings, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in our insurance underwriting operations with some indication of profit potential subject to the levels of our retentions, expenses and loss costs.

*Net premiums written*

While net premiums earned is the related GAAP measure used in the statements of earnings, net premiums written is the component of net premiums earned that measures the difference between gross premiums written and the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in our insurance underwriting operations. It provides some indication of profit potential subject to our expenses and loss costs.

*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. 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 referred to in our disclosures regarding the process of establishing these various estimated amounts.

**Critical Accounting Policies**

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In preparing the unaudited condensed consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the condensed consolidated financial statements

and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates.

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

### ***Losses and Settlement Expenses***

#### *Overview*

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

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

Due to inherent uncertainty underlying loss reserve estimates, including but not limited to the future settlement environment, final resolution of the estimated liability may be different from that anticipated at the reporting date. Therefore, actual paid losses in the future may yield a materially different amount than currently reserved favorable 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 a particular claim. The estimate reflects all of the current information available regarding the claim, the informed judgment of our professional claim personnel, our reserving practices and experience, and the knowledge of such personnel regarding the nature and value of the specific type of claim. During the life cycle of a particular claim, more information may materialize that causes us to revise the estimate of the ultimate value of the claim either upward or downward. We may determine that it is appropriate to pay portions of the reserve to the claimant or related settlement expenses before final resolution of the claim. The amount of the individual claim reserve will be adjusted accordingly and is based on the most recent information available.

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

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

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

All decisions regarding our best estimate of ultimate loss and LAE reserves are made by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief



operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at September 30, 2010, make a reasonable provision to meet our future obligations.

#### *Initial IBNR Generation Process*

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

For most property products, we use an alternative method of determining an appropriate provision for initial IBNR. Since this segment is characterized by a shorter period of time between claim occurrence and claim settlement, the IBNR reserve is determined by an IBNR percentage applied to the last 12 months premium earned. No deductions for paid or case reserves are made. This alternative method of determining initial IBNR reacts more rapidly to the actual loss emergence and is more appropriate for our property products where final claim resolution occurs quickly.

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, model loss estimates based on our own exposures, industry loss estimates of the event, and 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 based on 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 mix and price change and loss cost inflation. The initial loss and ALAE ratios also reflect some provision for estimation risk. We consider estimation risk by segment and product line. A segment with greater overall volatility and uncertainty has greater estimation risk. Characteristics of segments and products with higher estimation risk include but are not limited to the following:

- Significant changes in underlying policy terms and conditions,
- A new business or one experiencing significant growth and/or high turnover,
- Small volume or lacking internal data requiring significant reliance on external data,
- Longer emergence patterns with exposures to latent unforeseen mass tort,
- High severity and/or low frequency,
- Operational processes undergoing significant change, and/or
- High sensitivity to significant swings in loss trends or economic change.

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

*Loss and LAE Reserve Estimation Process*

A full analysis of our loss reserves takes place at least semi-annually. The purpose of these analyses 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 claims 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 new products, as well as for executive products and marine business, we utilize external data extensively.

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

We use historical development patterns, estimations of the expected loss ratios, and standard actuarial methods to derive an estimate of the ultimate level of loss and LAE payments necessary to settle all the claims occurring as of the end of the evaluation period. Once an estimate of the ultimate level of claim payments has been derived, the amount of paid loss and LAE and case reserve through the evaluation date is subtracted to reveal the resulting level of IBNR.

Our reserve processes include multiple standard actuarial methods for determining estimates of IBNR reserves. Other supplementary methodologies are incorporated as deemed necessary. Mass tort and latent liabilities are examples of exposures where supplementary methodologies are used. Each method produces an estimate of ultimate loss by accident year. We review all of these

various estimates and the actuaries assign weight to each based on the characteristics of the product being reviewed. The result is a single actuarial point estimate by product, by accident year.

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 or 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 process changes affecting timing of recording transactions,
- Regulatory and legal environment, and/or
- Economic environment.

Our actuaries engage in discussions with senior management, underwriting, and the claims department on a regular basis to attempt 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 material uncertainty. Different experts will choose different assumptions when faced with such uncertainty, based on their individual backgrounds, professional experiences, and areas of focus. Hence, the estimate selected by various qualified experts may differ materially 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. We have incorporated data validity checks and balances into our front-end processes. Data anomalies are researched and explained to reach a comfort level with the data and results. Leading indicators such as actual versus expected emergence and other diagnostics are also incorporated into the reserving processes.

#### *Determination of Our Best Estimate*

Upon completion of our full loss and LAE estimation analysis, the results are discussed with the LRC. As part of this discussion, the analysis supporting an indicated point estimate of the IBNR loss reserve by product is reviewed. The actuaries also present explanations supporting any changes to the underlying assumptions used to calculate the indicated point estimate. A review of the resulting variance between the indicated reserves and the carried reserves



determined from the initial IBNR generation process takes place. Quarterly, we also consider the most recent actual loss emergence compared to the expected loss emergence derived using the last full loss and LAE analyses. After discussion of these analyses and all relevant risk factors, the LRC determines whether the reserve balances require adjustment.

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

Actuarial methods attempt to quantify future events. 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 point estimate. Most of our variance between the carried reserve and the actuarial point estimate is in the most recent accident years for our casualty segment where the most significant estimation risks reside. In addition, some variance is carried on our surety segment where the impact of the economic environment is expected to emerge. These estimation risks are considered when setting the initial loss ratio for the product and segment. 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 our loss and LAE reserves may change depending on a revision in the actuarial point 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.

Loss reserve estimates are subject to a high degree of variability due to the inherent uncertainty of ultimate settlement values. Periodic adjustments to these estimates will likely occur as the actual loss emergence reveals itself over time. We believe our loss reserving processes and our methodologies result in a reasonable provision for reserves as of September 30, 2010.

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

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 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, 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 terms and covenants of the security. Qualitative criteria include the credit quality, current economic conditions, the anticipated speed of cost recovery, the financial health of and specific prospects for the issuer, as well as our intent and ability to hold the fixed income securities to maturity or the equity securities until forecasted recovery. In addition, we consider price declines of securities in our OTTI

analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

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

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

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

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

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

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

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, rather than being netted with the related liabilities, since reinsurance does

not relieve us of our liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. Additionally, the same uncertainties associated with estimating unpaid losses and settlement expenses impact the estimates for the ceded portion of such liabilities. We continually monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements, Securities and Exchange Commission filings, 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 collectibility tests, including one based on average default by S&P rating. Based upon our review and testing, our policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that we may be unable to recover. Further discussion of our reinsurance balances recoverable can be found in note 5 to the financial statements included in our 2009 Annual Report on Form 10-K.

#### *Deferred Policy Acquisition Costs*

We defer commissions, premium taxes and certain other costs that vary with and are primarily related to the acquisition of 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. 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 highly dependent upon estimated future loss costs associated with the premiums written. This deferral methodology applies to both gross and ceded premiums and acquisition costs. See discussion of a new proposed FASB guideline regarding accounting for DAC in Note 1 C of Notes to Unaudited Condensed Consolidated Interim Financial Statements .

#### *Deferred Taxes*

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

Since there is no absolute assurance that these assets will be ultimately realized, management reviews our deferred tax positions to determine if it is more-likely-than-not that the assets will be realized. Periodic reviews include, among other things, the nature and amount of the taxable income and expense items, the expected timing of when assets will be used or liabilities will be required to be reported and the reliability of historical profitability of businesses expected to provide future earnings. Furthermore, management considers tax-planning strategies it can use to increase the likelihood that the tax assets will be realized. If after conducting the periodic review, management determines that the realization of the tax asset



does not meet the more-likely-than-not criteria, an offsetting valuation allowance is recorded, thereby reducing net earnings and the deferred tax asset in that period. In addition, management must make estimates of the tax rates expected to apply in the periods in which future taxable items are realized. Such estimates include determinations and judgments as to the expected manner in which certain temporary differences, including deferred amounts related to our equity method investment, will be recovered and thereby the applicable tax rates. These estimates are subject to change based on the circumstances.

We consider uncertainties in income taxes and recognize those in our financial statements as required. As it relates to uncertainties in income taxes, our unrecognized tax benefits, including interest and penalty accruals, are not considered material to the unaudited condensed consolidated interim financial statements. Also, no tax uncertainties are expected to result in significant increases or decreases to unrecognized tax benefits within the next 12-month period. Penalties and interest related to income tax uncertainties, should they occur, would be included in tax expense. During the third quarter of 2010, the IRS concluded its examination of the income tax returns for the years 2005-2009. The tax impact from the proposed adjustments did not have a material effect on the condensed consolidated interim financial statements for the quarter. We also received the tax refunds from the carry back of the 2009 capital losses during the third quarter. We are now current from a federal examination perspective.

**NINE MONTHS ENDED SEPTEMBER 30, 2010, COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2009**

Consolidated revenues, as displayed in the table that follows, totaled \$431.8 million for the first nine months of 2010 compared to \$400.6 million for the same period in 2009.

	<b>For the Nine-Month Periods Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Consolidated revenues</b> (in thousands)		
Net premiums earned	\$ 366,356	\$ 370,910
Net investment income	50,127	50,494
Net realized investment gains (losses)	15,281	(20,789)
<b>Total consolidated revenue</b>	<b>\$ 431,764</b>	<b>\$ 400,615</b>

Consolidated revenue for the first nine months of 2010 increased \$31.1 million, or 8%, from the same period in 2009. Net premiums earned for the Group decreased 1% from 2009 levels, as casualty writings continue to decline due primarily to the impact of the economy and overall rate softening. Net investment income declined 1% to \$50.1 million. Current asset allocation strategies have focused on limiting the impact of volatility in the equity markets, while placing a higher portfolio allocation to short-term investments. We realized net investment gains of \$15.3 million in the first nine months of 2010, compared to net losses of \$20.8 million in the first nine months of 2009. Investment losses for 2009 were the result of impairment losses due to unease in the financial system and overall market volatility.

Net after-tax earnings for the first nine months of 2010 totaled \$87.2 million, \$4.11 per diluted share, compared to \$63.3 million, \$2.91 per diluted

share for the same period in 2009. Both periods benefited from positive underwriting income that was bolstered by favorable reserve development. In 2010, favorable development on prior years' loss and hurricane reserves resulted in additional pretax earnings of \$53.8 million compared to \$45.2 million in 2009. Partially offsetting this favorable development in 2010 was \$1.6 million in charges to reinstate a portion of prior year reinsurance coverage exhausted by loss activity on our marine coverage, as well as \$5.0 million in storm losses. Bonus and profit sharing-related expenses associated with these specific items totaled \$6.4 million in 2010 and \$7.2 million in 2009. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital).

During the first nine months of 2010, equity in earnings of unconsolidated investee totaled \$7.3 million from Maui Jim, Inc. (Maui Jim). The first nine months of 2009 reflected \$5.2 million in Maui Jim income. In 2010, Maui Jim, a producer of premium sunglasses, has experienced increased net sales, both domestically and internationally.

Results for the first nine months of 2010 included pretax net realized gains of \$15.3 million, compared to pretax net realized losses of \$20.8 million for the same period last year. The majority of the 2010 gains relate to sales of municipal bond securities. We have reduced our overall exposure to this asset class given concerns over the financial conditions of state/local municipalities. The securities sold resulted in the recognition of net realized gains. Results for 2009 were impacted by \$45.2 million of impairment losses.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (loss) (primarily the change in unrealized gains/losses net of tax), totaled \$115.2 million, \$5.42 per diluted share, for the first nine months of 2010, compared to comprehensive earnings of \$126.6 million, \$5.82 per diluted share, for the same period in 2009. Unrealized gains, net of tax, for the first nine months of 2010 were \$28.0 million, compared to unrealized gains of \$63.4 million for the same period in 2009. To date, our asset allocation strategies have focused on reducing our municipal exposures where we believe the slowing economy has put pressure on financial conditions and reallocating proceeds into high quality, low duration fixed income securities.

## **RLI INSURANCE GROUP**

As reflected in the table below, gross premiums written for the Group were up slightly, increasing 1% to \$489.7 million for the first nine months of 2010. Expansion efforts and new product offerings in the property and surety segments fueled growth in 2010, while casualty writings continued to decline. Underwriting income for the Group increased to \$65.2 million for the first nine months of 2010 compared to \$63.2 million in 2009. The GAAP combined ratio totaled 82.2 in 2010, compared to 82.9 in 2009. The Group's loss ratio remained flat at 42.4, while the Group's expense ratio decreased slightly to 39.8 from 40.4.

	For the Nine-Month Periods Ended September 30,	
	2010	2009
<b>Gross premiums written</b> (in thousands)		
Casualty	\$ 231,917	\$ 254,933
Property	188,071	163,959
Surety	69,690	68,336
Total	\$ 489,678	\$ 487,228
<b>Underwriting income</b> (in thousands)		
Casualty	\$ 23,691	\$ 37,380
Property	22,669	19,271
Surety	18,882	6,571
Total	\$ 65,242	\$ 63,222
<b>Combined ratio</b>		
Casualty	86.4	81.6
Property	82.9	83.3
Surety	68.1	87.5
Total	82.2	82.9

### Casualty

Gross premiums written for the casualty segment totaled \$231.9 million for the first nine months of 2010, a decrease of \$23.0 million, or 9%, from the same period last year. This segment continues to feel the pressure of rate reductions. General liability, our largest casualty product, recorded gross premiums written of \$75.9 million, a decrease of \$13.4 million, or 15%, from the same period last year. Nearly 50% of the general liability book is construction-related. The continued reduction in construction activity, along with rate deterioration, has had a negative impact on general liability gross premiums written. Specialty program gross premiums written totaled \$4.4 million for 2010, a decrease of \$5.6 million, or 56%, from the same period last year. This decrease is reflective of our continued re-underwriting of the book, including exiting certain unprofitable classes of business. Transportation recorded gross premiums written of \$37.1 million for the first nine months of 2010, down \$4.2 million, or 10%, from the same period last year. Commercial umbrella gross premiums written totaled \$18.9 million, a decrease of \$3.6 million, or 16%, from the same period last year. On a positive note, written premium for design professionals advanced \$5.3 million during the first nine months of 2010 from the same period last year to \$10.3 million. This product, which provides professional liability for architects and engineers, was launched in late 2008. Despite competitive pressures in the casualty segment, we remained disciplined in writing only those accounts that we believe will provide adequate returns. The soft marketplace is likely to continue to challenge our ability to grow premium in this segment this year.

In total, the casualty segment recorded underwriting income of \$23.7 million, compared to \$37.4 million for the same period last year. Both periods included favorable development on prior years' loss reserves. Products with favorable development in 2010 include commercial and personal umbrella, transportation, executive products, specialty program and general liability.

Due to positive emergence, during the first nine months of 2010, we released reserves, improving the segment's underwriting results by \$40.9 million. From an accident year standpoint, the majority of the favorable development occurred on accident years 2005 through 2008 and on 2009 for some of the shorter-tail products. From a comparative standpoint, results for 2009 included \$49.2 million of favorable loss experience on prior accident years, primarily for general liability, transportation, commercial and personal umbrella and executive products. Accident years contributing the most to the release were 2005 through 2008.

Overall, the combined ratio for the casualty segment was 86.4 for 2010 compared to 81.6 in 2009. The segment's loss ratio was 52.2 in 2010 compared to 47.7 in 2009, primarily driven by the higher amount of aforementioned favorable development in 2009 on prior accident years. In addition, increases in current accident year loss development have contributed to a higher loss ratio in 2010. The expense ratio for the casualty segment was 34.2 for the first nine months of 2010 compared to 33.9 for the same period of 2009. Expenses decreased in total for the segment in the first nine months of 2010, but the expense ratio is higher as a percentage of the decreased net premium earned.

### *Property*

Gross premiums written for the Group's property segment totaled \$188.1 million for the first nine months of 2010, an increase of \$24.1 million, or 15%, from the same period last year. The increase is attributable to recent product launches. On January 1, 2010, we initiated a crop reinsurance program in which we began assuming multi-peril crop insurance (MPCI) and crop hail premium and exposure under a quota share agreement. The new crop reinsurance agreement added \$27.0 million in gross premiums written in the first nine months of 2010. In addition, our facultative reinsurance division, launched in 2007, grew 46% from the same period last year to \$12.5 million in gross premiums written as it continues to build out its footprint. Lastly, other property reinsurance agreements, which were launched in the later part of 2009, expanded in the second quarter of 2010 to include industry loss warranty (ILW) treaties. Under the ILW treaties, we provide reinsurance coverage for windstorm and flood losses if two loss triggers (an industry loss limit trigger and a retention trigger) are met. Our diversification effort into these other assumed reinsurance arrangements added gross premiums written of \$3.4 million in the first nine months of 2010. Offsetting these increases, difference-in-conditions (DIC) gross premiums written decreased \$5.0 million, or 13%, to \$34.5 million for the first nine months of 2010 as we continue to manage our exposures and rate adequacy. In addition, our marine division decreased 13% to \$40.4 million. The exit from the commercial tug and tow business, which began in April 2009, has resulted in reduced premium writings for marine.

Underwriting income for the segment was \$22.7 million for the first nine months of 2010, compared to \$19.3 million for the same period in 2009. Results for 2010 reflect \$0.9 million of favorable development on hurricane reserves and \$1.9 million of favorable development on prior years' marine loss reserves, primarily on accident years 2008 and 2009. Offsetting that favorable development, results include \$5.0 million in storm losses. In addition, marine's underwriting results included charges of \$1.6 million to reinstate a portion of reinsurance coverage exhausted by prior year ceded loss.

activity. Specifically, ceded loss reserves were increased by \$8.2 million on one large liability loss, which exhausted a portion of reinsurance coverage. As a result, we incurred additional expense to reinstate the related reinsurance layers. Since we had previously reached the majority of our retention on this loss, the resulting net incurred loss increase was minimal. From a comparative standpoint, 2009 underwriting results were negatively impacted by a \$10.2 million IBNR reserve increase for marine, offset by \$2.7 million of favorable development on 2008 hurricane reserves and \$0.8 million of other favorable development, primarily on construction reserves.

Segment results for 2010 translate into a combined ratio of 82.9, compared to 83.3 for the same period last year. The segment's loss ratio was 47.0 in 2010 compared to 43.1 in 2009, partially due to storm losses. From an expense standpoint, the segment's expense ratio decreased to 35.9 for 2010 from 40.2 for 2009 partially as a result of expense control measures as well as lower bonuses and profit sharing-related expenses due to a lower return on operating earnings. Our crop reinsurance business also has an effect on both the loss and expense ratios as it carries a higher loss booking ratio and lower acquisition rate than other products in the casualty segment. This impact is reflected in the 2010 increase in loss ratio and decrease in expense ratio.

### ***Surety***

The surety segment recorded gross premiums written of \$69.7 million for the first nine months of 2010, an increase of \$1.4 million, or 2%, from the same period last year. Investment in underwriting capacity, which included geographic expansion and investment in additional underwriters, has served to increase gross premiums written. Premium growth was experienced across commercial, contract, and energy lines. Partially offsetting this growth, gross premiums written for our fidelity line declined \$4.6 million as we re-evaluated expanded policy terms and conditions currently available in the marketplace for this product. The segment recorded underwriting income of \$18.9 million, compared to \$6.6 million for the same period last year. Results for 2010 included favorable development on prior accident years' loss reserves, which improved the segment's underwriting results by \$10.1 million. During 2009, we held up additional reserves due to our concerns over the economy and the normal delayed-impact on contract and commercial surety accounts. During the first nine months of 2010, loss activity on these lines continued to be low. Given the short-tail nature of surety losses, we began to release the additional reserves that were established. From a comparative standpoint, 2009 results include favorable loss development which improved the segment's underwriting results by \$0.4 million.

The combined ratio for the surety segment totaled 68.1 in 2010, versus 87.5 for the same period in 2009. The segment's loss ratio was 2.8 for 2010, compared to 21.2 for 2009, due to the aforementioned favorable development in 2010 on prior accident years. From an expense standpoint, the segment's expense ratio decreased slightly to 65.3 for 2010 from 66.3 for 2009.

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

After a strong first quarter and a volatile second quarter, the capital markets rebounded with a strong performance in the third quarter. Based mostly on speculation of Federal Reserve actions, equity markets have rallied

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despite continued high unemployment rates and growing government deficits. Interest rates continued their decline during the quarter and our duration held constant at 3.5 from the end of the second quarter to the end of the third quarter. In a low interest rate environment, we opted not to extend duration. We have focused on defensive securities which should provide better protection in a rising interest rate environment.

(in thousands)	9/30/2010		12/31/2009	
	Financial Stmt Value	%	Financial Stmt Value	%
Fixed income	1,543,769	78.0%	1,485,347	80.2%
Equity securities	301,594	15.3%	262,693	14.2%
Short-term investments	133,018	6.7%	104,462	5.6%
Total	1,978,381	100.0%	1,852,502	100.0%

Our current equity allocation represents 15% of our total investment portfolio.

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

During the first nine months of 2010, net investment income decreased 1% from that reported for the same period in 2009. The decrease in investment income resulted as we eliminated higher-yielding equity securities including preferred stocks, a high-yield municipal bond fund, and REITs after the first quarter of 2009 and held a relatively high allocation of lower yielding short-term investments.

The average annual yields on our fixed income investments (excluding short-term investments) for the first six months of 2010 and 2009 were as follows:

	2010	2009
<u>Pretax Yield</u>		
Taxable	4.59%	5.12%
Tax-Exempt	3.77%	3.94%
<u>After-tax yield</u>		
Taxable	2.98%	3.33%
Tax-Exempt	3.57%	3.73%

The fixed income portfolio increased by \$58.4 million in the first nine months of 2010. This portfolio had a tax-adjusted total return on a mark-to-market basis of 7.3%. The equity portfolio had a total return of 4.3% for the first three quarters of 2010. Our equity portfolio increased by \$38.9 million during the first nine months of 2010, to \$301.6 million.

We recognized a total of \$15.3 million in net realized gains in the first nine months of 2010, compared to net realized losses of \$20.8 million in the first nine months of 2009. Of the 2009 net total, \$45.2 million of gross losses related to OTTI charges.

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The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity stock portfolio as

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of September 30, 2010, including fair value, cost basis, and unrealized gains and losses.

	Cost Basis	Fair Value	9/30/2010 Unrealized		Net	Unrealized Gain/Loss % (1)
			Gains	Losses		
			(dollars in thousands)			
Consumer Discretionary	\$ 16,531	\$ 20,226	\$ 3,695	\$	\$ 3,695	22.4%
Consumer Staples	13,110	26,791	13,681		13,681	104.4%
Energy	10,635	19,939	9,304		9,304	87.5%
Financials	22,637	25,427	3,750	(960)	2,790	12.3%
Healthcare	7,800	15,411	7,886	(275)	7,611	97.6%
Industrials	16,797	29,429	12,632		12,632	75.2%
Materials	5,538	6,555	1,051	(34)	1,017	18.4%
Information Technology	17,905	26,086	8,276	(95)	8,181	45.7%
Telecommunications	4,867	9,578	4,711		4,711	96.8%
Utilities	37,551	52,449	15,128	(230)	14,898	39.7%
ETF	63,643	69,703	6,060		6,060	9.5%
	\$ 217,014	\$ 301,594	\$ 86,174	\$ (1,594)	\$ 84,580	39.0%

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

In addition to our equity portfolio shown above, we maintain an allocation to municipal fixed income securities. As of September 30, 2010, we had \$249.9 million in municipal securities. As of September 30, 2010, approximately 31% of our municipal bond portfolio maintains an AAA rating, and 95% of our municipal bond portfolio maintains an AA or better rating. At December 31, 2009, approximately 17% of our municipal bond portfolio had an AAA rating, while 83% of our municipal bond portfolio held an AA or better rating.

### INCOME TAXES

Our effective tax rate for the first nine months of 2010 was 32% compared to 28% for the same period in 2009. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the first nine months of 2010 was higher due to a significant increase in realized investment gains, a slight increase in underwriting income and a decrease in tax-favored investment income. Dividends received are down and we have reduced our overall level of investments in tax-exempt securities. Realized investment gains were \$15.3 million in 2010 compared to \$20.8 million of realized investment losses in 2009, or a \$36.1 million swing between the two periods.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the first nine months of 2010 and 2009 as a result of the following:



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(in thousands)	2010		2009	
	Amount	%	Amount	%
Provision for income taxes at the Statutory rate of 35%	\$ 44,812	35%	\$ 30,725	35%
Increase (reduction) in taxes resulting from:				
Tax exempt interest income	(2,561)	-2%	(4,036)	-5%
Dividends received deduction	(992)	-1%	(1,086)	-1%
Dividends paid deduction	(453)	0%	(420)	0%
Other items, net	48	0%	(681)	-1%
Total tax expense	\$ 40,854	32%	\$ 24,502	28%

**LIQUIDITY AND CAPITAL RESOURCES**

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

The following table summarizes cash flows for the nine-month periods ended September 30, 2010 and 2009:

	2010		2009	
	(in thousands)			
Operating cash flows	\$ 87,867	\$ 108,445		
Investing cash flows	\$ (52,744)	\$ (101,397)		
Financing cash flows	\$ (35,123)	\$ (7,048)		
Total	\$	\$		

Cash flows from operating activities decreased during the first nine months of 2010 compared to that reported for the same period in 2009, due largely to a decrease in premiums receipts. Premium receipts are down most noticeably in our casualty segment, where gross premiums written declined \$23.0 million for the first nine months of 2010. On an overall basis, gross premiums written were down 2% for the third quarter of 2010 and are flat year-to-date. Also impacting cash flows from operating activities, tax payments increased, as did certain other payments. Partially offsetting these declines in operating cash, reinsurance receipts increased during the first nine months of the year. Our common stock repurchase program resulted in a higher use of cash for financing activities during the first nine months of 2010, compared to 2009.

We have \$100.0 million in long-term debt outstanding. On December 12, 2003, we completed a public debt offering, issuing \$100.0 million in senior notes maturing January 15, 2014 (a 10-year maturity), and paying interest semi-annually at the rate of 5.95% per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. The estimated fair value for the senior note at September 30, 2010 was \$103.5

million. The fair value of our long-term debt is estimated based on the limited observable prices that reflect thinly traded securities.

We are not party to any off-balance sheet arrangements or special-purpose entities.

As of September 30, 2010, we had short-term investments and other investments maturing within one year of approximately \$201.7 million and investments of \$417.7 million maturing within five years. As of September 30, 2010, our short-term investments were held in prime funds within multiple fund families, including JP Morgan, Federated, and Fidelity. All funds are NAIC-approved, AAA-rated, and maintain average weighted maturities of less than 60 days. Holdings within each of these funds comply with regulatory limitations. Whereas our strategy is to be fully invested at all times, short-term investments in excess of demand deposit balances are considered a component of investment activities, and thus are classified as investments in our consolidated balance sheets.

We also maintain a revolving line of credit with JPMorgan 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, 2011. As of September 30, 2010, no amounts were outstanding on this facility.

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

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

We maintain a well-diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of September 30, 2010, our investment portfolio had a book value of \$1.8 billion. Invested assets at September 30, 2010, increased by \$125.9 million from December 31, 2009.

As of September 30, 2010, our investment portfolio had the following asset allocation breakdown:

**Portfolio Allocation**

(in thousands)

Asset Class	Cost or Amortized Cost	Fair Value	Unrealized Gain/(Loss)	% of Total Fair Value	Quality
Agencies	\$ 364,589	\$ 367,982	\$ 3,393	18.6%	AAA
Corporates	552,391	600,916	48,525	30.3%	A
Mortgage-backed	253,436	265,957	12,521	13.5%	AAA
Asset-backed	46,533	49,657	3,124	2.5%	AAA
Treasuries	10,891	11,309	418	0.6%	AAA
Munis	238,666	249,908	11,242	12.6%	AA
<b>Total Fixed Income</b>	<b>\$ 1,466,506</b>	<b>\$ 1,545,729</b>	<b>\$ 79,223</b>	<b>78.1%</b>	<b>AA</b>
<b>Equities</b>	<b>\$ 217,014</b>	<b>\$ 301,594</b>	<b>\$ 84,580</b>	<b>15.2%</b>	
<b>Short-term investments</b>	<b>\$ 133,018</b>	<b>\$ 133,018</b>		<b>6.7%</b>	
<b>Total Portfolio</b>	<b>\$ 1,816,538</b>	<b>\$ 1,980,341</b>	<b>\$ 163,803</b>	<b>100.0%</b>	

Our investment portfolio does not have any exposure to credit default swaps or derivatives. We completely exited our securities lending program as of June 30, 2009.

As of September 30, 2010, our fixed income portfolio had the following rating distribution:

<b>AAA</b>	<b>50.9%</b>
<b>AA</b>	<b>14.5%</b>
<b>A</b>	<b>24.2%</b>
<b>BBB</b>	<b>10.1%</b>
<b>NR</b>	<b>0.3%</b>
<b>Total</b>	<b>100.0%</b>

As of September 30, 2010, the duration of the fixed income portfolio was 3.5 years. Our fixed income portfolio remained well diversified, with 567 individual issues as of September 30, 2010.

Our investment portfolio has limited exposure to structured asset-backed products. As of September 30, 2010, we had \$10.9 million in asset-backed securities which are pools of assets collateralized by cash flows from several types of loans, including home equity, credit cards, autos, and similar obligations. The majority of our asset-backed portfolio is comprised of rate reduction utility bonds.

As of September 30, 2010 we did not hold any securities that are classified as subprime home equity. We had \$38.7 million in securities backed by commercial mortgages and \$266.0 million in securities backed by conforming government-sponsored enterprise (Freddie Mac, Fannie Mae and Ginnie Mae) residential loans. Excluding the conforming Freddie Mac, Fannie Mae, and Ginnie Mae mortgages, our exposure to asset-backed products and commercial mortgage-backed securities was three percent of our investment portfolio as of September 30, 2010.

At September 30, 2010, our equity portfolio had a fair value of \$301.6 million and is also a source of liquidity. The securities within the equity portfolio

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

As of September 30, 2010, our equity portfolio had a dividend yield of 2.8% compared to 2.0% for the S&P 500 index. Because of the corporate dividend-received-deduction applicable to our dividend income, we pay an effective tax rate of only 14.2% on dividends, compared to 35.0% on taxable interest and 5.3% on municipal bond interest income. As with our bond portfolio, we maintain a well-diversified group of 80 equity securities.

Our capital structure is comprised of equity and debt outstanding. As of September 30, 2010, our capital structure consisted of \$100.0 million in 10-year maturity senior notes maturing in 2014 (long-term debt) and \$912.2 million of shareholders' equity. Debt outstanding comprised 11.0% of total capital as of September 30, 2010.

We paid a quarterly cash dividend of \$0.29 per share on October 15, 2010, the same amount as the prior quarter. We have paid dividends for 137 consecutive quarters and increased dividends in each of the last 35 years.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authority of Illinois. The maximum distribution in a rolling 12-month period is limited by Illinois law to the greater of 10% of policyholder surplus as of December 31 of the preceding year or the net income of the Company for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend that can be paid by RLI Insurance Company in a rolling 12-month period ending in 2010 without prior approval is \$78.4 million which represents 10% of RLI Insurance Company's policyholder surplus at December 31, 2009. The total dividend paid in the first nine months of 2010 was \$58.0 million. Other dividends paid in the previous three months totaled \$20.0 million, bringing the total for the rolling 12-month period to \$78.0 million. These dividends are paid to provide additional capital to RLI Corp. from RLI Insurance Company and are used for shareholder dividends, interest on senior notes, and general corporate expenses.

Interest and fees on debt obligations totaled \$4.5 million for the first nine months of 2010 and 2009. As of September 30, 2010, outstanding debt balances totaled \$100.0 million, the same amount outstanding at September 30, 2009. Debt balances at September 30, 2010 and September 30, 2009 were comprised of \$100.0 million in senior notes. We have incurred interest expense on debt at the following average interest rates for the nine-month periods ended September 30, 2010 and 2009:

	2010	2009
Line of Credit	NA	NA
Reverse repurchase agreements	NA	NA
Total short-term debt	NA	NA
Senior Notes	6.02%	6.02%
Total Debt	6.02%	6.02%

**THREE MONTHS ENDED SEPTEMBER 30, 2010 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2009**

Consolidated revenues, as displayed in the table that follows, totaled \$149.6 million for the third quarter of 2010 compared to \$146.0 million for the same period in 2009.

	For the Three-Month Period Ended September 30,	
	2010	2009
<b>Consolidated revenues</b> (in thousands)		
Net premiums earned	\$ 128,334	\$ 122,736
Net investment income	16,762	16,295
Net realized investment gains	4,527	6,985
Total consolidated revenue	\$ 149,623	\$ 146,016

Consolidated revenue for the third quarter of 2010 increased \$3.6 million, or 3%, from the same period in 2009. Net premiums earned for the Group increased despite the continued decline in casualty writings due to overall rate softening. This increase is primarily attributable to the addition of our crop reinsurance program. Net investment income increased 3% to \$16.8 million. Net realized investments gains totaled \$4.5 million in the third quarter of 2010, compared to \$7.0 million in 2009.

Net after-tax earnings for the third quarter of 2010 totaled \$28.0 million, \$1.33 per diluted share, compared to \$31.0 million, \$1.42 per diluted share, for the same period in 2009. In the third quarter of 2010, favorable development on prior years' loss and hurricane reserves resulted in additional pretax earnings of \$23.0 million. Comparatively, in the third quarter of 2009, favorable development on prior years' loss and hurricane reserves resulted in additional pretax earnings of \$18.2 million. Partially offsetting the favorable development in the third quarter of 2010 was an increase in current accident year losses on casualty. During the quarter, adverse loss experience on our general liability product resulted in an increase to the loss ratio. Also impacting the loss ratio in the quarter is our crop reinsurance business. It has the effect of increasing the loss ratio in the quarter, while partially offsetting with a decrease to the expense ratio due to its lower acquisition rate. Bonus and profit sharing-related expenses related to the favorable development on prior years' reserves totaled \$2.7 million in 2010 and \$3.2 million in 2009. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital).

During the third quarter of 2010, equity in earnings of unconsolidated investee totaled \$1.6 million from Maui Jim. The third quarter of 2009 reflected \$1.1 million in Maui Jim income.

Results for the third quarter of 2010 included pretax net realized gains of \$4.5 million, compared to \$7.0 million, for the same period last year. Realized gains are taxed at the statutory rate of 35%.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$58.4 million, \$2.77 per diluted share, for the third quarter of 2010,



compared to \$68.0 million, \$3.12 per diluted share, for the same period in 2009. Unrealized gains, net of tax, for the third quarter of 2010 were \$30.5 million, compared to unrealized gains, net of tax, of \$37.0 million for the same period in 2009. Current asset allocation strategies have focused on continuing to reduce municipal exposures where we believe financial conditions are weakened due to a slowing economy and reallocating proceeds into high quality, low duration fixed income securities.

## RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group declined slightly to \$157.4 million for the third quarter of 2010 from \$159.9 million in the third quarter of 2009. New product offerings fueled growth in the third quarter of 2010 in the property segment, while casualty writings continued to decline. The surety segment also experienced decline in the third quarter of 2010 as energy lines declined from the same period last year. Underwriting income for the Group declined \$1.2 million to \$21.7 million for the third quarter of 2010. Both periods benefited from favorable development on prior accident years' loss and hurricane reserve releases. The GAAP combined ratio totaled 83.1 in 2010, compared to 81.3 in 2009.

	For the Three-Month Period Ended September 30,	
	2010	2009
<b>Gross premiums written</b> (in thousands)		
Casualty	\$ 78,789	\$ 83,337
Property	53,930	51,177
Surety	24,687	25,406
Total	\$ 157,406	\$ 159,920
<b>Underwriting income</b> (in thousands)		
Casualty	\$ 8,906	\$ 17,330
Property	5,288	3,914
Surety	7,532	1,708
Total	\$ 21,726	\$ 22,952
<b>Combined ratio</b>		
Casualty	84.5	73.2
Property	89.4	90.2
Surety	63.6	90.6
Total	83.1	81.3

### Casualty

Gross premiums written for the casualty segment totaled \$78.8 million for the third quarter of 2010, a decrease of \$4.5 million, or 6%, from the same period last year. While the rate of decline improved from the first two quarters' postings, this segment continued to feel the pressure of rate reductions. General liability, our largest casualty product, recorded gross premiums written of \$21.1 million for the third quarter of 2010, down 17% from the same period last year. As discussed previously, nearly 50% of the general liability book is construction-related. The continued reduction in construction activity, along with rate deterioration, has had a negative



impact on general liability gross premiums written. Specialty program gross premiums written totaled \$1.0 million for 2010, a decrease of \$0.9 million, or 46%, from the third quarter of 2009. This decrease is reflective of our continued re-underwriting of the book, including exiting certain unprofitable classes of business. Commercial umbrella recorded gross premiums written of \$5.9 million for the third quarter of 2010, down \$1.5 million, or 20%, from the same period last year. On a positive note, written premium for design professionals advanced \$1.4 million during the third quarter of 2010 to \$4.3 million. This product, which provides professional liability for architects and engineers, was launched in late 2008.

In total, the casualty segment recorded underwriting income of \$8.9 million, compared to \$17.3 million for the same period last year. Both periods included favorable development on prior years' loss reserves. Products with favorable development in 2010 included commercial and personal umbrella, transportation, executive products, specialty program and general liability. Due to positive emergence, during the third quarter of 2010, we released reserves which improved the segment's underwriting results by \$18.4 million. From a comparative standpoint, results for 2009 included \$19.1 million of favorable loss experience on prior accident years, primarily for general liability, transportation and commercial and personal umbrella.

Overall, the combined ratio for the casualty segment was 84.5 for 2010 compared to 73.2 in 2009. The segment's loss ratio was 49.1 in 2010 compared to 37.4 in 2009. It was a difficult quarter in terms of the current accident year. Adverse loss experience on our general liability product resulted in a \$5.8 million increase in current accident year losses which served to decrease underwriting income and increase the loss ratio. We are currently taking underwriting action on the habitational book of business. We are exiting some of the larger habitational policies and increasing rates on others. The increase in loss ratio is also partially driven by the higher amount of favorable development in 2009 on prior accident years. The expense ratio for the casualty segment was 35.4 for the third quarter of 2010 compared to 35.8 for the same period of 2009.

### *Property*

Gross premiums written for the Group's property segment totaled \$53.9 million for the third quarter of 2010, an increase of \$2.8 million, or 5%, from the same period last year. The increase is attributable to recent product launches. On January 1, 2010, we initiated a crop reinsurance program in which we began assuming multi-peril crop insurance (MPCI) and crop hail premium and exposure under a quota share agreement. The new crop reinsurance agreement added \$3.7 million in gross premiums written in the third quarter of 2010. In addition, our facultative reinsurance division, launched in 2007, grew 31% to \$3.6 million in gross premiums written for the third quarter of 2010 as it continued to build out its footprint. Lastly, other property reinsurance agreements, which were launched in the later part of 2009, expanded in the second quarter of 2010 to include industry loss warranty (ILW) treaties. Our diversification effort into these other assumed reinsurance arrangements added gross premiums written of \$1.3 million in the third quarter of 2010. Offsetting these increases, gross premiums written from our marine division decreased \$2.1 million, or 14%, to \$13.4 million for the third quarter of 2010. The exit from the commercial tug and tow business, which began in April 2009, has resulted in reduced premium writings for marine.

Underwriting income for the segment was \$5.3 million for the third quarter of 2010, compared to \$3.9 million for the same period in 2009. Results for 2010 included \$1.5 million of storm losses which were partially offset by \$1.1 million of favorable development on prior years' loss and hurricane reserves. From a comparative standpoint, underwriting results for 2009 were negatively impacted by unfavorable loss experience on the commercial tug and towing class of business. As a direct result of poor underwriting results in this marine class, we increased IBNR reserves on current and prior accident years for the affected coverages. These additions negatively impacted 2009 results by \$4.2 million. This was partially offset by \$0.6 million of favorable development on 2008 hurricane reserves.

Segment results for 2010 translate into a combined ratio of 89.4, compared to 90.2 for the same period last year. The segment's loss ratio increased to 55.4 from 48.7 in 2009, primarily driven by the aforementioned increase in storm losses in the quarter. From an expense standpoint, the segment's expense ratio for the third quarter was 34.0 for 2010, compared to 41.5 in 2009. While net operating expenses for 2010 increased slightly, the decrease in the expense ratio was primarily attributable to the increase in net premiums earned.

### *Surety*

The surety segment recorded gross premiums written of \$24.7 million for the third quarter of 2010, a decrease of \$0.7 million, or 3%, from the same period last year. Gross premiums written for the energy line declined 18% during the third quarter of 2010 to \$4.9 million. Our fidelity division, which launched in September 2008, contributed gross premiums written of \$1.1 million in the third quarter of 2010, down 51% from the same period last year as we re-evaluated expanded policy terms and conditions currently available in the marketplace for this product. Partially offsetting these declines, premium growth was experienced across commercial, contract, and miscellaneous lines and served to increase the top-line by \$1.4 million. The surety segment recorded underwriting income of \$7.5 million, compared to \$1.7 million for the same period last year. Results for 2010 included favorable development on prior accident years' loss reserves, which improved the segment's underwriting results by \$3.5 million. During 2009, we held up additional reserves due to our concerns over the economy and the normal delayed-impact on contract and commercial surety accounts. In the third quarter of 2010, loss activity on these lines continued to be low. Given the short-tail nature of surety losses, we continued to release the additional reserves that were established. From a comparative standpoint, 2009 results included favorable loss development which improved the segment's underwriting results by \$0.3 million.

The combined ratio for the surety segment totaled 63.6 for the third quarter of 2010, versus 90.6 for the same period in 2009. The segment's loss ratio was -1.0 for 2010, compared to 22.4 for 2009, as 2010 was favorably impacted by the aforementioned favorable reserve development. The favorable loss trends also led to lower current accident year booking ratios. The expense ratio was 64.6 compared to 68.2. Net operating expenses for 2010 increased slightly; however, the increase in net premiums earned for the period outpaced the increase in expenses. After the recent growth in revenues in the segment, the expense-base is being better leveraged, accounting for the decrease in expense ratio.

**INVESTMENT INCOME AND REALIZED CAPITAL GAINS**

Our investment portfolio generated net dividend and interest income of \$16.8 million during the third quarter of 2010, an increase of 2.9% from that reported for the same period in 2009. The increase in income is due to increased dividends and changes to our asset allocations. On an after-tax basis, investment income decreased by 1.2%.

Yields on our fixed income investments for the third quarter of 2010 and 2009 are as follows:

	3Q 2010	3Q 2009
<u>Pretax Yield</u>		
Taxable	4.40%	4.72%
Tax-Exempt	3.92%	3.97%
<u>After-tax yield</u>		
Taxable	2.86%	3.07%
Tax-Exempt	3.71%	3.76%

We recognized \$4.5 million in realized gains in the third quarter of 2010, compared to realized gains of \$7.0 million in the third quarter of 2009. Investment gains during the quarter primarily related to the sale of equities and municipal securities. These sales were made based on our belief that other securities offer greater potential for us to achieve our investment objectives.

We did not record any realized losses associated with OTTI of securities during the third quarter of 2010.

At September 30, 2010, we did not impair any securitized fixed income bonds. All of these securities are rated AAA by a major rating agency, continue to pay contractual interest payments as agreed, and no security had an unrealized loss greater than 20% of amortized cost. In addition, our cash flow projections indicate that we fully expect to recover the amortized cost basis with no credit loss to principal.

In the third quarter of 2009, there were no losses associated with impaired securities.

**INCOME TAXES**

Our effective tax rate for the third quarter of 2010 was 32% compared to 29% for the same period in 2009. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the third quarter of 2010 was higher due to a significant decrease in tax-favored investment income.

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Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the third quarter of 2010 and 2009 as a result of the following:

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(in thousands)	2010		2009	
	Amount	%	Amount	%
Provision for income taxes at the Statutory rate of 35%	\$ 14,351	35%	\$ 15,282	35%
Increase (reduction) in taxes resulting from:				
Tax exempt interest income	(689)	-2%	(1,255)	-3%
Dividends received deduction	(338)	-1%	(346)	-1%
Dividends paid deduction	(154)	0%	(144)	0%
Other items, net	(132)	0%	(893)	-2%
<b>Total tax expense</b>	<b>\$ 13,038</b>	<b>32%</b>	<b>\$ 12,644</b>	<b>29%</b>

### 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 90% rated A or better by at least one nationally recognized rating organization.

On an overall basis, our exposure to market risk has not significantly changed from that reported in our December 31, 2009 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.

In the second quarter of 2010, we completed our \$200 million share repurchase program initiated in 2007. On May 6, 2010, our Board of Directors implemented a new \$100 million share repurchase program. The repurchase program may be suspended or discontinued at any time without prior notice. During the third quarter of 2010, we repurchased 35,475 shares for \$2.0 million under the plans. The transactions occurred pursuant to open market purchases.

The table below shows our repurchases of the Company's common stock during the third quarter of 2010.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program
July 1, 2010 - July 31, 2010	35,475	\$ 56.39	35,475	\$ 94,124,732
August 1, 2010 - August 31, 2010				94,124,732
September 1, 2010 - September 30, 2010				94,124,732
Total	35,475		35,475	\$ 94,124,732

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

**Item 4. Submission of Matters to a Vote of Security Holders** - Not Applicable

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

**Item 6. Exhibits**

Exhibit 10.1 RLI Corp. Long-Term Incentive Plan, incorporated by reference to the Form 8-K Current Report filed May 6, 2010



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

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

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

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

Exhibit 101 XBRL-Related Documents

**SIGNATURES**

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

RLI Corp.

/s/Joseph E. Dondanville  
Joseph E. Dondanville  
Sr. Vice President, Chief Financial Officer  
(Principal Financial and  
Chief Accounting Officer)

Date: October 26, 2010