

RLI CORP  
Form 10-Q  
October 24, 2018  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

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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|  |  |
|--|--|
| Delaware<br>(State or other jurisdiction of<br>incorporation or organization)      | 37-0889946<br>(I.R.S. Employer<br>Identification Number) |
| 9025 North Lindbergh Drive, Peoria, IL<br>(Address of principal executive offices) | 61615<br>(Zip Code)                                      |

(309) 692-1000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

|                         |                           |
|-------------------------|---------------------------|
| Large accelerated filer | Accelerated filer         |
| Non-accelerated filer   | Smaller reporting company |
|                         | Emerging growth company   |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of October 12, 2018, the number of shares outstanding of the registrant's Common Stock was 44,484,654.

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## RLI Corp. and Subsidiaries

## Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

| (in thousands, except per share data)                        | For the Three-Month Periods<br>Ended September 30, |            | For the Nine-Month Periods<br>Ended September 30, |            |
|--|--|------------|---|------------|
|  | 2018   | 2017       | 2018  | 2017       |
| Net premiums earned  | \$ 200,815   | \$ 182,025 | \$ 587,364  | \$ 549,641 |
| Net investment income  | 16,314   | 14,187     | 45,123  | 40,430     |
| Net realized gains   | 18,808   | 35         | 48,117  | 1,390      |
| Other-than-temporary impairment (OTTI) losses on investments | (161)  | -          | (217)   | (2,090)    |
| Net unrealized gains (losses) on equity securities           | 4,848  | -          | (34,535)  | -          |
| Consolidated revenue   | \$ 240,624   | \$ 196,247 | \$ 645,852  | \$ 589,371 |
| Losses and settlement expenses                               | 110,231  | 123,190    | 304,305   | 306,927    |
| Policy acquisition costs                                     | 68,414   | 62,066     | 201,473   | 186,264    |
| Insurance operating expenses                                 | 14,408   | 11,701     | 42,191  | 38,582     |
| Interest expense on debt                                     | 1,862  | 1,856      | 5,576   | 5,569      |
| General corporate expenses                                   | 2,947  | 1,956      | 7,871   | 7,816      |
| Total expenses   | \$ 197,862   | \$ 200,769 | \$ 561,416  | \$ 545,158 |
| Equity in earnings of unconsolidated investees               | 3,587  | 3,660      | 15,853  | 15,404     |
| Earnings (loss) before income taxes                          | \$ 46,349  | \$ (862)   | \$ 100,289  | \$ 59,617  |
| Income tax expense (benefit)                                 | 6,977  | (2,596)    | 15,450  | 11,847     |
| Net earnings   | \$ 39,372  | \$ 1,734   | \$ 84,839   | \$ 47,770  |
| Other comprehensive earnings (loss), net of tax              | (7,696)  | 8,444      | (41,769)  | 30,812     |
| Comprehensive earnings                                       | \$ 31,676  | \$ 10,178  | \$ 43,070   | \$ 78,582  |
| Earnings per share:  |  |            |   |            |
| Basic:   |  |            |   |            |
| Basic net earnings per share                                 | \$ 0.89  | \$ 0.04    | \$ 1.91   | \$ 1.09    |
| Basic comprehensive earnings per share                       | \$ 0.71  | \$ 0.23    | \$ 0.97   | \$ 1.79    |
| Diluted:   |  |            |   |            |
| Diluted net earnings per share                               | \$ 0.88  | \$ 0.04    | \$ 1.90   | \$ 1.07    |
| Diluted comprehensive earnings per share                     | \$ 0.70  | \$ 0.23    | \$ 0.96   | \$ 1.77    |

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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Weighted average number of common shares<br>outstanding: |         |         |         |         |
| Basic  | 44,400  | 44,058  | 44,311  | 44,008  |
| Diluted  | 44,940  | 44,515  | 44,760  | 44,517  |
| Cash dividends paid per common share                     | \$ 0.22 | \$ 0.21 | \$ 0.65 | \$ 0.62 |

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Balance Sheets

(Unaudited)

| (in thousands, except share data)   | September<br>30,<br>2018 | December<br>31,<br>2017 |
|---|--------------------------|-------------------------|
| <b>ASSETS</b>   |                          |                         |
| Investments and cash:   |                          |                         |
| Fixed income:   |                          |                         |
| Available-for-sale, at fair value (amortized cost - \$1,745,648 at 9/30/18 and \$1,646,411 at 12/31/17)   | \$ 1,719,617             | \$ 1,672,239            |
| Equity securities, at fair value (cost - \$210,119 at 9/30/18 and \$182,002 at 12/31/17)  | 394,375                  | 400,492                 |
| Short-term investments, at cost which approximates fair value   | 18,526                   | 9,980                   |
| Other invested assets   | 38,777                   | 33,808                  |
| Cash  | 59,469                   | 24,271                  |
| Total investments and cash  | \$ 2,230,764             | \$ 2,140,790            |
| Accrued investment income   | 14,417                   | 15,166                  |
| Premiums and reinsurance balances receivable, net of allowances for uncollectible amounts of \$17,076 at 9/30/18 and \$16,935 at 12/31/17                             | 138,480                  | 134,351                 |
| Ceded unearned premium  | 66,400                   | 57,928                  |
| Reinsurance balances recoverable on unpaid losses and settlement expenses, net of allowances for uncollectible amounts of \$9,827 at 9/30/18 and \$10,014 at 12/31/17 | 320,027                  | 301,991                 |
| Deferred policy acquisition costs   | 84,232                   | 77,716                  |
| Property and equipment, at cost, net of accumulated depreciation of \$52,418 at 9/30/18 and \$47,676 at 12/31/17  | 55,469                   | 55,849                  |
| Investment in unconsolidated investees  | 95,007                   | 90,067                  |
| Goodwill and intangibles  | 54,626                   | 59,302                  |
| Other assets  | 14,100                   | 14,084                  |
| <b>TOTAL ASSETS</b>   | <b>\$ 3,073,522</b>      | <b>\$ 2,947,244</b>     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                          |                         |
| <b>Liabilities</b>  |                          |                         |
| Unpaid losses and settlement expenses   | \$ 1,377,111             | \$ 1,271,503            |
| Unearned premiums   | 483,305                  | 451,449                 |
| Reinsurance balances payable  | 18,396                   | 21,624                  |
| Funds held  | 73,304                   | 74,560                  |
| Income taxes-deferred   | 38,260                   | 53,768                  |
| Bonds payable, long-term debt   | 149,068                  | 148,928                 |
| Accrued expenses  | 45,420                   | 52,848                  |
| Other liabilities   | 16,802                   | 18,966                  |
| <b>TOTAL LIABILITIES</b>  | <b>\$ 2,201,666</b>      | <b>\$ 2,093,646</b>     |
| <b>Shareholders' Equity</b>   |                          |                         |



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|   |                     |                     |
|---|---------------------|---------------------|
| Common stock (\$0.01 par value at 9/30/18 and \$1.00 par value at 12/31/17)<br>(100,000,000 shares authorized at 9/30/18 and 12/31/17)<br>(67,414,868 shares issued, 44,484,654 shares outstanding at 9/30/18)<br>(67,078,569 shares issued, 44,148,355 shares outstanding at 12/31/17) | \$ 674              | \$ 67,079           |
| Paid-in capital   | 303,399             | 233,077             |
| Accumulated other comprehensive earnings  | (22,344)            | 157,919             |
| Retained earnings   | 983,126             | 788,522             |
| Deferred compensation   | 7,765               | 8,640               |
| Less: Treasury shares at cost<br>(22,930,214 shares at 9/30/18 and 12/31/17)  | (400,764)           | (401,639)           |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>   | <b>\$ 871,856</b>   | <b>\$ 853,598</b>   |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>   | <b>\$ 3,073,522</b> | <b>\$ 2,947,244</b> |

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

| (in thousands)                            | For the Nine-Month Periods<br>Ended September 30, |              |
|---|---|--------------|
|   | 2018  | 2017         |
| Net cash provided by operating activities | \$ 163,369  | \$ 145,933   |
| Cash Flows from Investing Activities      |   |              |
| Investments purchased                     | \$ (636,859)                                      | \$ (335,361) |
| Investments sold                          | 444,637   | 131,605      |
| Investments called or matured             | 102,244   | 103,193      |
| Net change in short-term investments      | (8,546)   | (6,910)      |
| Net property and equipment purchased      | (4,838)   | (7,262)      |
| Other                                     | 89  | 408          |
| Net cash used in investing activities     | \$ (103,273)                                      | \$ (114,327) |
| Cash Flows from Financing Activities      |   |              |
| Cash dividends paid                       | \$ (28,815)                                       | \$ (27,288)  |
| Stock plan share issuance                 | 3,917   | 4,290        |
| Net cash used in financing activities     | \$ (24,898)                                       | \$ (22,998)  |
| Net increase in cash                      | \$ 35,198   | \$ 8,608     |
| Cash at the beginning of the period       | \$ 24,271   | \$ 18,269    |
| Cash at September 30                      | \$ 59,469   | \$ 26,877    |

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. DESCRIPTION OF BUSINESS

RLI Corp. (the “Company”) is an insurance holding company that was organized in 1965. On May 4, 2018, RLI Corp. changed its state of incorporation from the State of Illinois to the State of Delaware (the “Reincorporation”). The Reincorporation was effected by merging RLI Corp., an Illinois corporation (“RLI Illinois”) into RLI Corp., a Delaware corporation (“RLI Delaware”). The separate corporate existence of RLI Illinois ceased and RLI Delaware continues in existence as the surviving corporation and possesses all rights, privileges, powers and franchises of RLI Illinois. The Reincorporation did not result in any change in the name, business, management, fiscal year, location of the principal executive offices, assets or liabilities of the Company. Each outstanding share of RLI Illinois common stock, which had a par value of \$1.00 per share, was automatically converted into one outstanding share of RLI Delaware common stock, with a par value of \$0.01 per share. In order to reflect the new par value of common stock on the balance sheet, a \$66.6 million reclassification from common stock to paid-in-capital was made during the second quarter. For more information on the Reincorporation, see RLI Corp.’s Form 8-K filed on May 7, 2018.

B. 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 2017 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, 2018 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. Certain reclassifications were made to 2017 to conform to the classifications used in the current year.

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

### C. ADOPTED ACCOUNTING STANDARDS

#### ASU 2014-09, Revenue from Contracts with Customers (Topic 606)

ASU 2014-09 was issued to clarify and remove inconsistencies within revenue recognition requirements. The core principle of the update is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, the transaction price for a contract is allocated among separately identifiable performance obligations and a portion of the transaction price is recognized as revenue when the associated performance obligation has been completed or transferred to the customer. All contracts and fulfillment activities within the scope of Topic 944, Financial Services – Insurance, investment income, investment related gains and losses and equity in earnings of unconsolidated investees are outside the scope of this ASU.

We adopted ASU 2014-09 on January 1, 2018. However, nearly all (over 99 percent) of our consolidated revenue is scoped out and therefore exempt from the guidance contained within this ASU. For the remaining portion, the revenue recognition policy we utilize aligns with the new guidance and there were no changes to the way we recognize revenue. Although the recognition of earnings from equity method investees is out of scope from the update, the recognition of revenue by our equity method investees would be subject to the new guidance if the revenue streams are within this update's scope. Any impact on revenues would affect the net income of each of the equity method investees, upon which we calculate our portion of earnings to recognize. Our equity method investees are private companies and this guidance becomes effective for private companies in periods beginning after December 15, 2018. As a result, their earnings and our portion of those earnings

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are not impacted in 2018. We expect that revenue generated by both of our equity method investees will either be outside the scope of this update or largely unaffected by the changes.

ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

This ASU was issued to improve the recognition and measurement of financial instruments. The new guidance makes targeted improvements to GAAP as follows:

- a. Requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net earnings;
- b. Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment;
- c. Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet;
- d. Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes;
- e. Requires an entity to present separately in other comprehensive earnings the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments;
- f. Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and
- g. Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

We adopted ASU 2016-01 on January 1, 2018. A cumulative-effect adjustment to the balance sheet was made as of the beginning of the year, which moved \$142.2 million of net unrealized gains and losses on equity securities from accumulated other comprehensive earnings to retained earnings. During the first nine months of 2018, we recognized \$34.5 million of unrealized losses on equity securities within net earnings and \$7.3 million of income tax benefit. This compares to \$14.6 million of unrealized gains on equity securities, net of tax, that was recognized through other comprehensive earnings for the comparable period in 2017. The future impact to our net earnings will vary depending upon the level of volatility in the performance of the securities held in our equity portfolio and the overall market.

ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments

ASU 2016-15 was issued to reduce the diversity in practice of how certain cash receipts and payments, for which current guidance is silent, are classified in the statement of cash flows. The update addresses eight specific issues, including contingent consideration payments made after a business combination, distributions received from equity method investees and the classification of cash receipts and payments that have aspects of more than one class of cash

flows. We adopted ASU 2016-15 on January 1, 2018. The adoption did not have a material impact on our statement of cash flows.

ASU 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

ASU 2018-02 was issued as a result of the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA) on December 22, 2017. Accounting guidance required deferred tax items to be revalued based on the new tax laws (the most significant of which reduced the corporate tax rate to 21 percent from 35 percent) with the change included in income from continuing operations. Since other comprehensive income was not affected by the revaluation of the deferred tax items, the net accumulated other comprehensive income (AOCI) balance was reflective of the historic 35 percent tax rate instead of the newly enacted rate, a difference that is referred to as a stranded tax effect. This ASU allows for the option to reclassify the stranded tax effects resulting from the implementation of the TCJA out of AOCI and into retained earnings. ASU 2018-02 does not replace the guidance requiring changes from the enactment of other tax laws or rates to be included within income from continuing operations and is applicable only to changes from the TCJA.

We adopted ASU 2018-02 during the first quarter of 2018. A current period adjustment was made to the balance sheet, which moved \$3.7 million of stranded tax effects on the unrealized balances of our fixed income securities and equity method investees from accumulated other comprehensive earnings to retained earnings. The entire unrealized balance on equity securities was reclassified from AOCI into retained earnings from the adoption of ASU 2016-01 on January 1, 2018 and was

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therefore unaffected by this ASU. As there was no impact to net earnings and the balance sheet effect is limited to a reclassification within the equity section, there was not a material impact on our financial statements.

D. PROSPECTIVE ACCOUNTING STANDARDS

ASU 2016-02, Leases (Topic 842)

ASU 2016-02 was issued to improve the financial reporting of leasing transactions. Under current guidance for lessees, leases are only included on the balance sheet if certain criteria, classifying the agreement as a capital lease, are met. This update will require the recognition of a right-of-use asset and a corresponding lease liability, discounted to the present value, for all leases that extend beyond 12 months. For operating leases, the asset and liability will be expensed over the lease term on a straight-line basis, with all cash flows included in the operating section of the statement of cash flows. For finance leases, interest on the lease liability will be recognized separately from the amortization of the right-of-use asset in the statement of comprehensive income and the repayment of the principal portion of the lease liability will be classified as a financing activity while the interest component will be included in the operating section of the statement of cash flows.

This ASU is effective for annual and interim reporting periods beginning after December 15, 2018. Early adoption is permitted. ASU 2018-10, Codification Improvements to Topic 842, Leases was issued to clarify certain aspects of ASU 2016-02 and the two updates will be adopted concurrently. ASU 2016-02 requires leases to be recognized and measured at the beginning of the earliest period presented using a modified retrospective approach upon adoption. However, ASU 2018-11, Leases (Topic 842): Targeted Improvements provides an alternative transition method by which leases are recognized at the date of adoption and a cumulative-effective adjustment to the opening balance of retained earnings is recognized in the period of adoption. We plan to adopt using this alternative. Approximately \$33 million of undiscounted future lease liabilities would have to be discounted to present value and added to our balance sheet with a corresponding right-of-use asset if the guidance were applicable on September 30, 2018. We do not have any financing leases, but we do have approximately \$7 million of annual operating lease expenses. We do not expect that there will be a materially different annual rental expense upon adoption.

ASU 2016-13, Financial Instruments – Credit Losses (Topic 326)

ASU 2016-13 was issued to provide more decision-useful information about the expected credit losses on financial instruments. Current GAAP delays the recognition of credit losses until it is probable a loss has been incurred. The update will require a financial asset measured at amortized cost, including reinsurance balances recoverable, to be presented at the net amount expected to be collected by means of an allowance for credit losses that runs through net earnings. Credit losses relating to available-for-sale debt securities will also be recorded through an allowance for credit losses. However, the amendments would limit the amount of the allowance to the amount by which fair value is

below amortized cost. The measurement of credit losses on available-for-sale securities is similar under current GAAP, but the update requires the use of the allowance account through which amounts can be reversed, rather than through an irreversible write-down.

This ASU is effective for annual and interim reporting periods beginning after December 15, 2019. Early adoption is permitted beginning after December 15, 2018. Upon adoption, the update will be applied using the modified-retrospective approach, by which a cumulative-effect adjustment will be made to retained earnings as of the beginning of the first reporting period presented. This update will have the most impact on our available-for-sale fixed income portfolio and reinsurance balances recoverable. However, as our fixed income portfolio is weighted towards higher rated bonds (82.8 percent rated A or better at September 30, 2018), we purchase reinsurance from financially strong reinsurers and we already have an allowance for uncollectible reinsurance amounts, we do not expect that the effect of adoption will be material.

ASU 2017-08, Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities

Under current practices, the amortization period for callable debt securities held at a premium is generally the contractual life of the instrument. However, if an entity has a large number of similar loans, it may consider estimates of future principal prepayments. For those who choose to not incorporate an estimate of future prepayments, ASU 2017-08 shortens the amortization period for premium on debt securities to the earliest call date, rather than the maturity date, to align the amortization method with how the securities are quoted, priced and traded. After the earliest call date, if the call option is not exercised, the entity shall reset the effective yield using the payment terms of the debt security. Any excess of the amortized cost basis over the amount payable will be amortized to the next call date or to maturity if there are no other call dates. The method of accounting for a discount does not change and will continue to be amortized over the life of the bond.



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This ASU is effective for annual and interim reporting periods beginning after December 15, 2018. Early adoption is permitted. The update will be applied using a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. As we currently incorporate estimates of future principal prepayments when calculating the effective yield for bonds carrying a premium, we do not expect the adoption of this update to have a material impact on our financial statements.

ASU 2018-07, Compensation-Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

ASU 2018-07 was issued to simplify the accounting for share-based transactions by expanding the scope of Topic 718 from only being applicable to share-based payments to employees to also include share-based payment transactions for acquiring goods and services from nonemployees. As a result, nonemployee share-based transactions will be measured by estimating the fair value of the equity instruments at the grant date, taking into consideration the probability of satisfying performance conditions. This ASU is effective for annual and interim reporting periods beginning after December 15, 2018. Early adoption is permitted. Our long term incentive plan limits the awards of share-based payments to employees and directors of the Company or any affiliate. The share-based compensation expense to nonemployee directors was \$0.2 million in the first nine months of 2018. Costs associated with such payments are not expected to materially increase and we do not expect this update to have a material impact on our financial statements.

ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement

ASU 2018-13 modifies the disclosure requirements for assets and liabilities measured at fair value. The requirements to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, the policy for timing of transfers between levels and the valuation processes for Level 3 fair value measurements have all been removed. However, the changes in unrealized gains and losses included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period must be disclosed along with the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements (or other quantitative information if it is more reasonable). Finally, for investments measured at net asset value, the requirements have been modified so that the timing of liquidation and the date when restrictions from redemption might lapse are only disclosed if the investee has communicated the timing to the entity or announced the timing publicly.

This ASU is effective for annual and interim reporting periods beginning after December 15, 2019. As the amendments are only disclosure related and we do not currently have any assets or liabilities that are measured based on Level 3 inputs, our financial statements will not be materially impacted by this update.

ASU 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract

ASU 2018-15 requires a customer in a cloud computing arrangement (i.e. hosting arrangement) that is a service contract to follow the internal-use software guidance to determine which implementation costs to capitalize as assets or expense as incurred. Relevant implementation costs in the development stage are capitalized, while costs incurred during the preliminary project and post-implementation stages are expensed as the activities are performed. Capitalized costs are expensed over the term of the hosting arrangement. This ASU is effective for annual and interim reporting periods beginning after December 15, 2019. Early adoption is permitted. This update can either be applied retrospectively or prospectively to all implementation costs incurred after the date of adoption. We have not yet completed the analysis of how adopting this ASU will affect our financial statements.

E. INTANGIBLE ASSETS

Goodwill and intangible assets totaled \$54.6 million and \$59.3 million at September 30, 2018 and December 31, 2017, respectively, as detailed in the following table.

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|  | September<br>30,<br>2018 | December<br>31,<br>2017 |
|--|--------------------------|-------------------------|
| Goodwill and Intangible Assets<br>(in thousands)   |                          |                         |
| Goodwill   |                          |                         |
| Energy surety  | \$ 25,706                | \$ 25,706               |
| Miscellaneous and contract surety  | 15,110                   | 15,110                  |
| Small commercial   | 5,246                    | 5,246                   |
| Medical professional liability *   | -                        | 3,595                   |
| Total goodwill   | \$ 46,062                | \$ 49,657               |
| Intangibles  |                          |                         |
| State insurance licenses   | \$ 7,500                 | \$ 7,500                |
| Definite-lived intangibles, net of accumulated amortization of \$2,929 at 9/30/18<br>and \$5,678 at 12/31/17 | 1,064                    | 2,145                   |
| Total intangibles  | \$ 8,564                 | \$ 9,645                |
| Total goodwill and intangibles   | \$ 54,626                | \$ 59,302               |

\* The medical professional liability goodwill balance reflects a cumulative non-cash impairment charge of \$12.4 million and \$8.8 million as of September 30, 2018 and December 31, 2017, respectively.

All definite-lived intangible assets are amortized against future operating results based on their estimated useful lives. Amortization of intangible assets was \$0.1 million for the third quarter of 2018 and \$0.3 million for the nine-month period ended September 30, 2018, compared to \$0.2 million for the third quarter of 2017 and \$0.6 million for the nine-month period ended September 30, 2017.

Annual impairment testing was performed on our energy surety goodwill, miscellaneous and contract surety goodwill, small commercial goodwill and state insurance license indefinite-lived intangible asset during the second quarter of 2018. Based upon these reviews, none of the assets were impaired. In addition, as of September 30, 2018, there were no triggering events that would suggest an updated review was necessary on the above mentioned goodwill and intangible assets.

As previously disclosed, adverse loss experience triggered the need to test the medical professional liability reporting unit during the first quarter of 2018 and the second quarter of 2017. The testing resulted in a \$4.4 million non-cash impairment charge in 2018 and a \$3.4 million non-cash impairment charge in 2017. In each instance, a fair value for the medical professional liability reporting unit's agency relationships, carried as a definite-lived intangible, was determined by using a discounted cash flow valuation. In 2018, the carrying value exceeded the fair value, resulting in a \$0.8 million non-cash impairment charge. In 2017, the resulting non-cash impairment charge on definite-lived intangibles was \$1.8 million. A fair value for the medical professional liability reporting unit's goodwill was determined by using a weighted average of a market approach and discounted cash flow valuation. The carrying value exceeded the fair value in each year, resulting in a \$3.6 million non-cash impairment charge in the first quarter of

2018 and a \$1.6 million non-cash impairment charge during the second quarter of 2017. Subsequent to the first quarter 2018 impairment, the medical professional liability reporting unit had no remaining goodwill or intangible assets. All impairment charges were recorded as net realized losses in the respective period's consolidated statement of earnings.

#### F. EARNINGS PER SHARE

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock or common stock equivalents were exercised or converted into common stock. When inclusion of common stock equivalents increases the earnings per share or reduces the loss per share, the effect on earnings is anti-dilutive. Under these circumstances, the diluted net earnings or net loss per share is computed excluding the common stock equivalents. The following represents a reconciliation of the numerator and denominator of the basic and diluted EPS computations contained in the unaudited condensed consolidated interim financial statements.

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| (in thousands, except per share data)   | For the Three-Month Period Ended September 30, 2018 |                         |                     | For the Three-Month Period Ended September 30, 2017 |                         |                     |
|---|---|-------------------------|---------------------|---|-------------------------|---------------------|
|   | Income<br>(Numerator)                               | Shares<br>(Denominator) | Per Share<br>Amount | Income<br>(Numerator)                               | Shares<br>(Denominator) | Per Share<br>Amount |
| Basic EPS                               |   |                         |                     |   |                         |                     |
| Income available to common shareholders | \$ 39,372   | 44,400                  | \$ 0.89             | \$ 1,734  | 44,058                  | \$ 0.04             |
| Effect of Dilutive Securities           |   |                         |                     |   |                         |                     |
| Stock options                           | -   | 540                     |                     | -   | 457                     |                     |
| Diluted EPS                             |   |                         |                     |   |                         |                     |
| Income available to common shareholders | \$ 39,372   | 44,940                  | \$ 0.88             | \$ 1,734  | 44,515                  | \$ 0.04             |
|   |   |                         |                     |   |                         |                     |
| (in thousands, except per share data)   | For the Nine-Month Period Ended September 30, 2018  |                         |                     | For the Nine-Month Period Ended September 30, 2017  |                         |                     |
|   | Income<br>(Numerator)                               | Shares<br>(Denominator) | Per Share<br>Amount | Income<br>(Numerator)                               | Shares<br>(Denominator) | Per Share<br>Amount |
| Basic EPS                               |   |                         |                     |   |                         |                     |
| Income available to common shareholders | \$ 84,839   | 44,311                  | \$ 1.91             | \$ 47,770   | 44,008                  | \$ 1.09             |
| Effect of Dilutive Securities           |   |                         |                     |   |                         |                     |
| Stock options                           | -   | 449                     |                     | -   | 509                     |                     |
| Diluted EPS                             |   |                         |                     |   |                         |                     |
| Income available to common shareholders | \$ 84,839   | 44,760                  | \$ 1.90             | \$ 47,770   | 44,517                  | \$ 1.07             |

**G. COMPREHENSIVE EARNINGS**

Our comprehensive earnings include net earnings plus after-tax unrealized gains and losses on our fixed income portfolio in 2018. In 2017, after-tax unrealized gains and losses on our equity portfolio were also included. With the adoption of ASU 2016-01 on January 1, 2018, we began recognizing unrealized gains and losses on the equity portfolio through net income. See note 1.C to the unaudited condensed consolidated interim financial statements for more information. In reporting comprehensive earnings on a net basis in the statement of earnings, we used the federal statutory tax rate of 21 percent in 2018 and 35 percent in 2017.

Unrealized losses, net of tax, on the fixed income portfolio for the first nine months of 2018 were \$41.8 million, compared to \$30.8 million of unrealized gains, net of tax, on the fixed income and equity portfolios during the same period last year. Unrealized losses in the first nine months of 2018 were attributable to rising interest rates, which decreased the fair value of securities held in the fixed income portfolio. In 2017, unrealized gains were primarily the result of tightening credit spreads which increased the fair value of fixed income securities, though positive pricing movements in equity securities also contributed.

The following table illustrates the changes in the balance of each component of accumulated other comprehensive earnings for each period presented in the unaudited condensed consolidated interim financial statements. The 2017 activity and balances include the net unrealized gain and loss activity on both fixed income and equity securities, while the 2018 activity and ending balance reflect only the net unrealized gain and loss activity on fixed income securities due to the aforementioned adoption of ASU 2016-01.

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| (in thousands)   | For the Three-Month Periods<br>Ended September 30, |            | For the Nine-Month Periods<br>Ended September 30, |            |
|--|--|------------|---|------------|
|  | 2018   | 2017       | 2018  | 2017       |
| Unrealized Gains/Losses on Available-for-Sale Securities           |  |            |   |            |
| Beginning balance  | \$ (14,648)  | \$ 144,978 | \$ 157,919  | \$ 122,610 |
| Cumulative effect adjustment of ASU 2016-01                        | -  | -          | (142,219)   | -          |
| Adjusted beginning balance   | \$ (14,648)  | \$ 144,978 | \$ 15,700   | \$ 122,610 |
| Other comprehensive earnings before reclassifications              | (7,034)  | 9,141      | (41,829)  | 33,066     |
| Amounts reclassified from accumulated other comprehensive earnings | (662)  | (697)      | 60  | (2,254)    |
| Net current-period other comprehensive earnings (loss)             | \$ (7,696)   | \$ 8,444   | \$ (41,769)                                       | \$ 30,812  |
| Reclassification of stranded tax effect per ASU 2018-02            | -  | -          | 3,725   | -          |
| Ending balance   | \$ (22,344)  | \$ 153,422 | \$ (22,344)                                       | \$ 153,422 |

The sale or other-than-temporary impairment of an available-for-sale security results in amounts being reclassified from accumulated other comprehensive earnings to current period net earnings. The effects of reclassifications out of accumulated other comprehensive earnings by the respective line items of net earnings are presented in the following table. As previously mentioned, 2018 activity is reflective of activity on fixed income securities classified as available-for-sale, while 2017 also includes activity from the equity portfolio.

| (in thousands)   | Amount Reclassified from Accumulated Other Comprehensive Earnings |          |  |          | Affected line item in the Statement of Earnings              |
|--|---|----------|--|----------|--|
|  | For the Three-Month Periods Ended September 30,                   |          | For the Nine-Month Periods Ended September 30, |          |  |
| Component of Accumulated Other Comprehensive Earnings        | 2018  | 2017     | 2018   | 2017     |  |
| Unrealized gains and losses on available-for-sale securities | \$ 999  | \$ 1,073 | \$ 141   | \$ 5,558 | Net realized gains (losses)                                  |
|  | (161)   | -        | (217)  | (2,090)  | Other-than-temporary impairment (OTTI) losses on investments |
|  | \$ 838  | \$ 1,073 | \$ (76)  | \$ 3,468 | Earnings (loss) before income taxes                          |
|  | (176)   | (376)    | 16   | (1,214)  | Income tax expense (benefit)                                 |
|  | \$ 662  | \$ 697   | \$ (60)  | \$ 2,254 | Net earnings (loss)  |

## 2. INVESTMENTS

Our investments are primarily composed of fixed income debt securities and common stock equity securities. We carry our equity securities at fair value and categorize all of our debt securities as available-for-sale, which are carried at fair value. 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."



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## Fixed Income Securities - Available-for-Sale

The amortized cost and fair value of available-for-sale securities at September 30, 2018 and December 31, 2017 were as follows:

Available-for-sale  
(in thousands)

| Asset Class             | September 30, 2018     |                        |                         |              |
|-------------------------|------------------------|------------------------|-------------------------|--------------|
|                         | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value   |
| U.S. government         | \$ 177,339             | \$ 8                   | \$ (3,560)              | \$ 173,787   |
| U.S. agency             | 30,647                 | 111                    | (855)                   | 29,903       |
| Non-U.S. govt. & agency | 8,178                  | -                      | (271)                   | 7,907        |
| Agency MBS              | 415,476                | 1,299                  | (14,749)                | 402,026      |
| ABS/CMBS*               | 120,737                | 113                    | (1,283)                 | 119,567      |
| Corporate               | 675,731                | 2,862                  | (11,901)                | 666,692      |
| Municipal               | 317,540                | 4,727                  | (2,532)                 | 319,735      |
| Total Fixed Income      | \$ 1,745,648           | \$ 9,120               | \$ (35,151)             | \$ 1,719,617 |

Available-for-sale  
(in thousands)

| Asset Class             | December 31, 2017      |                        |                         |              |
|-------------------------|------------------------|------------------------|-------------------------|--------------|
|                         | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value   |
| U.S. government         | \$ 92,561              | \$ 23                  | \$ (895)                | \$ 91,689    |
| U.S. agency             | 18,541                 | 347                    | (110)                   | 18,778       |
| Non-U.S. govt. & agency | 7,501                  | 143                    | (56)                    | 7,588        |
| Agency MBS              | 329,129                | 3,420                  | (4,078)                 | 328,471      |
| ABS/CMBS*               | 70,405                 | 436                    | (315)                   | 70,526       |
| Corporate               | 508,128                | 12,575                 | (1,681)                 | 519,022      |
| Municipal               | 620,146                | 17,272                 | (1,253)                 | 636,165      |
| Total Fixed Income      | \$ 1,646,411           | \$ 34,216              | \$ (8,388)              | \$ 1,672,239 |

\*Non-agency asset-backed and commercial mortgage-backed

The following table presents the amortized cost and fair value of available-for-sale debt securities by contractual maturity dates as of September 30, 2018:

| Available-for-sale<br>(in thousands)  | September 30, 2018 |               |
|---------------------------------------|--------------------|---------------|
|                                       | Amortized<br>Cost  | Fair<br>Value |
| Due in one year or less               | \$ 41,952          | \$ 42,115     |
| Due after one year through five years | 379,636            | 378,403       |
| Due after five years through 10 years | 611,198            | 602,738       |
| Due after 10 years                    | 176,649            | 174,768       |
| Mtge/ABS/CMBS*                        | 536,213            | 521,593       |
| Total available-for-sale              | \$ 1,745,648       | \$ 1,719,617  |

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

#### Unrealized Losses on Fixed Income Securities

We conduct and document periodic reviews of all fixed income 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 fixed income securities that were in an unrealized loss position as of September 30, 2018 and December 31, 2017. The tables segregate the securities based on type, noting the fair value, cost (or amortized cost) and unrealized loss on each category of

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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, 2018, unrealized losses on fixed income securities, as shown in the following tables, were 1.6 percent of total invested assets. Unrealized losses increased through the first nine months of 2018, as interest rates increased from the end of 2017, which decreased the fair value of securities held in the fixed income portfolio.

| (in thousands)             | September 30, 2018 |                   |             | December 31, 2017 |                   |            |
|----------------------------|--------------------|-------------------|-------------|-------------------|-------------------|------------|
|                            | < 12 Mos.          | 12 Mos. & Greater | Total       | < 12 Mos.         | 12 Mos. & Greater | Total      |
| <b>U.S. Government</b>     |                    |                   |             |                   |                   |            |
| Fair value                 | \$ 72,347          | \$ 99,558         | \$ 171,905  | \$ 58,009         | \$ 30,888         | \$ 88,897  |
| Cost or amortized cost     | 72,981             | 102,484           | 175,465     | 58,443            | 31,349            | 89,792     |
| Unrealized Loss            | \$ (634)           | \$ (2,926)        | \$ (3,560)  | \$ (434)          | \$ (461)          | \$ (895)   |
| <b>U.S. Agency</b>         |                    |                   |             |                   |                   |            |
| Fair value                 | \$ 17,408          | \$ 10,384         | \$ 27,792   | \$ 10,917         | \$ —              | \$ 10,917  |
| Cost or amortized cost     | 17,622             | 11,025            | 28,647      | 11,027            | —                 | 11,027     |
| Unrealized Loss            | \$ (214)           | \$ (641)          | \$ (855)    | \$ (110)          | \$ —              | \$ (110)   |
| <b>Non-U.S. government</b> |                    |                   |             |                   |                   |            |
| Fair value                 | \$ 6,214           | \$ 1,693          | \$ 7,907    | \$ —              | \$ 1,840          | \$ 1,840   |
| Cost or amortized cost     | 6,280              | 1,898             | 8,178       | —                 | 1,896             | 1,896      |
| Unrealized Loss            | \$ (66)            | \$ (205)          | \$ (271)    | \$ —              | \$ (56)           | \$ (56)    |
| <b>Agency MBS</b>          |                    |                   |             |                   |                   |            |
| Fair value                 | \$ 152,341         | \$ 206,541        | \$ 358,882  | \$ 122,130        | \$ 111,306        | \$ 233,436 |
| Cost or amortized cost     | 155,615            | 218,016           | 373,631     | 123,559           | 113,955           | 237,514    |
| Unrealized Loss            | \$ (3,274)         | \$ (11,475)       | \$ (14,749) | \$ (1,429)        | \$ (2,649)        | \$ (4,078) |
| <b>ABS/CMBS*</b>           |                    |                   |             |                   |                   |            |
| Fair value                 | \$ 82,967          | \$ 28,580         | \$ 111,547  | \$ 23,406         | \$ 21,587         | \$ 44,993  |
| Cost or amortized cost     | 83,647             | 29,183            | 112,830     | 23,491            | 21,817            | 45,308     |
| Unrealized Loss            | \$ (680)           | \$ (603)          | \$ (1,283)  | \$ (85)           | \$ (230)          | \$ (315)   |
| <b>Corporate</b>           |                    |                   |             |                   |                   |            |
| Fair value                 | \$ 387,421         | \$ 84,835         | \$ 472,256  | \$ 86,946         | \$ 28,600         | \$ 115,546 |
| Cost or amortized cost     | 395,327            | 88,830            | 484,157     | 87,736            | 29,491            | 117,227    |
| Unrealized Loss            | \$ (7,906)         | \$ (3,995)        | \$ (11,901) | \$ (790)          | \$ (891)          | \$ (1,681) |
| <b>Municipal</b>           |                    |                   |             |                   |                   |            |
| Fair value                 | \$ 56,839          | \$ 43,287         | \$ 100,126  | \$ 71,059         | \$ 60,049         | \$ 131,108 |

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|                        |             |             |              |            |            |            |
|------------------------|-------------|-------------|--------------|------------|------------|------------|
| Cost or amortized cost | 57,586      | 45,072      | 102,658      | 71,534     | 60,827     | 132,361    |
| Unrealized Loss        | \$ (747)    | \$ (1,785)  | \$ (2,532)   | \$ (475)   | \$ (778)   | \$ (1,253) |
| Total fixed income     |             |             |              |            |            |            |
| Fair value             | \$ 775,537  | \$ 474,878  | \$ 1,250,415 | \$ 372,467 | \$ 254,270 | \$ 626,737 |
| Cost or amortized cost | 789,058     | 496,508     | 1,285,566    | 375,790    | 259,335    | 635,125    |
| Unrealized Loss        | \$ (13,521) | \$ (21,630) | \$ (35,151)  | \$ (3,323) | \$ (5,065) | \$ (8,388) |

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\* Non-agency asset-backed and commercial mortgage-backed

The following table shows the composition of the fixed income securities in unrealized loss positions at September 30, 2018 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.

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| NAIC<br>Rating | Equivalent<br>S&P<br>Rating | Equivalent<br>Moody's<br>Rating | (dollars in thousands) |              | Unrealized<br>Loss | Percent<br>to Total |   |
|----------------|-----------------------------|---------------------------------|------------------------|--------------|--------------------|---------------------|---|
|                |                             |                                 | Amortized<br>Cost      | Fair Value   |                    |                     |   |
| 1              | AAA/AA/A                    | Aaa/Aa/A                        | \$ 1,103,857           | \$ 1,074,126 | \$ (29,731)        | 84.6                | % |
| 2              | BBB                         | Baa                             | 136,227                | 131,948      | (4,279)            | 12.2                | % |
| 3              | BB                          | Ba                              | 29,221                 | 28,491       | (730)              | 2.1                 | % |
| 4              | B                           | B                               | 14,712                 | 14,386       | (326)              | 0.9                 | % |
| 5              | CCC                         | Caa                             | 1,549                  | 1,464        | (85)               | 0.2                 | % |
| 6              | CC or lower                 | Ca or lower                     | -                      | -            | -                  | -                   | % |
|                |                             | Total                           | \$ 1,285,566           | \$ 1,250,415 | \$ (35,151)        | 100.0               | % |

## Evaluating Fixed Income Securities for OTTI

The fixed income portfolio contained 676 securities in an unrealized loss position as of September 30, 2018. The \$35.2 million in associated unrealized losses for these 676 securities represents 2.0 percent of the fixed income portfolio's cost basis. Of these 676 securities, 244 have been in an unrealized loss position for 12 consecutive months or longer. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. Any credit-related impairment related to fixed income securities we do not plan to sell and for which we are not more likely than not to be required to sell is recognized in net earnings, with the non-credit related impairment recognized in comprehensive earnings. Based on our analysis, our fixed income portfolio is of high credit quality and we believe we will recover the amortized cost basis of our fixed income securities. We continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. In the first nine months of 2018, we recognized \$0.2 million in other-than-temporary impairment (OTTI) charges in earnings on two fixed income securities. We no longer had the intent to hold one of the securities and a credit loss was taken on a second fixed income security that we do intend to hold. Comparatively, we recognized \$2.1 million in OTTI losses in earnings on two fixed income securities that we no longer had the intent to hold in the same period in 2017. There were no OTTI losses recognized in other comprehensive earnings on the fixed income portfolio for the periods presented.

## Unrealized Gains and Losses on Equity Securities

During the third quarter of 2018, net unrealized gains (losses) on equity securities included an unrealized gain of \$22.8 million on securities held as of September 30, 2018. Net unrealized gains on equity securities for the first nine months of 2018 included an unrealized gain of \$18.2 million on securities held as of September 30, 2018.

Other Invested Assets

We had \$38.8 million of other invested assets at September 30, 2018, compared to \$33.8 million at the end of 2017. Other invested assets include investments in low income housing tax credit partnerships (LIHTC), membership in the Federal Home Loan Bank of Chicago (FHLBC) and investments in private funds. Our LIHTC investments are carried at amortized cost and our investment in FHLBC stock is carried at cost. Due to the nature of the LIHTC and our membership in the FHLBC, their carrying amounts approximate fair value. The private funds are carried at fair value, using each investment's net asset value.

Our LIHTC interests had a balance of \$14.0 million at September 30, 2018, compared to \$15.5 million at December 31, 2017 and recognized a total tax benefit of \$0.6 million during the third quarter of 2018, the same period as the prior year. For the nine-month periods ended September 30, 2018 and 2017, our LIHTC interests recognized a total benefit of \$1.7 million and \$1.9 million, respectively. Our unfunded commitment for our LIHTC investments totaled \$2.0 million at September 30, 2018 and will be paid out in installments through 2025.

As of September 30, 2018, \$16.3 million of investments were pledged as collateral with the FHLBC to ensure timely access to the secured lending facility that ownership of FHLBC stock provides. As of and during the nine month period ending September 30, 2018, there were no outstanding borrowings with the FHLBC.

We had \$25.2 million of unfunded commitments related to our investments in private funds at September 30, 2018. Additionally, our interest in these investments is generally restricted from being transferred or otherwise redeemed without prior consent by the respective entities. An IPO would allow for the transfer of interest in some situations, while the timed dissolution of the partnership would trigger redemption in others.

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Cash and Short-term Investments

Cash consists of uninvested balances in bank accounts. We had a cash balance of \$59.5 million at September 30, 2018, compared to \$24.3 million at the end of 2017. As of September 30, 2018, we had \$18.5 million of short-term investments that were carried at cost and approximated fair value, compared to \$10.0 million at December 31, 2017.

3. FAIR VALUE MEASUREMENTS

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

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

We determined the fair value of certain financial instruments based on their underlying characteristics and relevant transactions in the marketplace. We maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Financial assets are classified based upon the lowest level of significant input that is used to determine fair value. The following are the levels of the fair value hierarchy and a brief description of the type of valuation inputs that are used to establish each level:

Pricing Level 1 is applied to valuations based on readily available, unadjusted quoted prices in active markets for identical assets.

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

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

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

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

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

**Common Stock:** All but one of our common stock holdings are traded on an exchange. Exchange traded equities have readily observable price levels and are classified as Level 1 (fair value based on quoted market prices). Pricing for the equity security not traded on an exchange is provided by a third-party pricing source and is classified as Level 2.



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

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

Our investments in private funds, classified as other invested assets, are carried at fair value and are measured using each investment's net asset value, but are not categorized within the fair value hierarchy.

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

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

| (in thousands)                                     | As of September 30, 2018   |   |   | Total        |
|--|--|---|---|--------------|
|  | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |              |
| Fixed income securities - available-for-sale       |  |   |   |              |
| U.S. government                                    | \$ —   | \$ 173,787                                    | \$ —                                      | \$ 173,787   |
| U.S. agency  | —  | 29,903  | —   | 29,903       |
| Non-U.S. govt. & agency                            | —  | 7,907   | —   | 7,907        |
| Agency MBS   | —  | 402,026                                       | —   | 402,026      |
| ABS/CMBS*  | —  | 119,567                                       | —   | 119,567      |
| Corporate  | —  | 666,692                                       | —   | 666,692      |
| Municipal  | —  | 319,735                                       | —   | 319,735      |
| Total fixed income securities - available-for-sale | \$ —   | \$ 1,719,617                                  | \$ —                                      | \$ 1,719,617 |

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|                   |            |              |      |              |
|-------------------|------------|--------------|------|--------------|
| Equity securities | 393,882    | 493          | —    | 394,375      |
| Total             | \$ 393,882 | \$ 1,720,110 | \$ — | \$ 2,113,992 |

| (in thousands)  | As of December 31, 2017<br>Fair Value Measurements Using                |  |  | Total        |
|---|---|--|--|--------------|
|   | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |              |
| Fixed income securities - available-for-sale          |   |  |  |              |
| U.S. government                                       | \$ —  | \$ 91,689  | \$ —   | \$ 91,689    |
| U.S. agency   | —   | 18,778   | —  | 18,778       |
| Non-U.S. govt. & agency                               | —   | 7,588  | —  | 7,588        |
| Agency MBS  | —   | 328,471  | —  | 328,471      |
| ABS/CMBS*   | —   | 70,526   | —  | 70,526       |
| Corporate   | —   | 519,022  | —  | 519,022      |
| Municipal   | —   | 636,165  | —  | 636,165      |
| Total fixed income securities -<br>available-for-sale | \$ —  | \$ 1,672,239   | \$ —   | \$ 1,672,239 |
| Equity securities                                     | 400,492   | —  | —  | 400,492      |
| Total   | \$ 400,492  | \$ 1,672,239   | \$ —   | \$ 2,072,731 |

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\* Non-agency asset-backed and commercial mortgage-backed

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As noted in the above table, we did not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period. Additionally, there were no securities transferred in or out of levels 1 or 2 during the nine-month period ended September 30, 2018.

## 4. HISTORICAL LOSS AND LAE DEVELOPMENT

The following table is a reconciliation of our unpaid losses and settlement expenses (LAE) for the first nine months of 2018 and 2017.

| (in thousands)                                 | For the Nine-Month Periods<br>Ended September 30, |              |
|--|---|--------------|
|  | 2018  | 2017         |
| Unpaid losses and LAE at beginning of year     |   |              |
| Gross  | \$ 1,271,503                                      | \$ 1,139,337 |
| Ceded  | (301,991)   | (288,224)    |
| Net  | \$ 969,512  | \$ 851,113   |
| Increase (decrease) in incurred losses and LAE |   |              |
| Current accident year                          | \$ 342,807  | \$ 343,535   |
| Prior accident years                           | (38,502)  | (36,608)     |
| Total incurred                                 | \$ 304,305  | \$ 306,927   |
| Loss and LAE payments for claims incurred      |   |              |
| Current accident year                          | \$ (45,008)                                       | \$ (37,333)  |
| Prior accident year                            | (171,725)   | (158,052)    |
| Total paid                                     | \$ (216,733)                                      | \$ (195,385) |
| Net unpaid losses and LAE at September 30,     | \$ 1,057,084                                      | \$ 962,655   |
| Unpaid losses and LAE at September 30,         |   |              |
| Gross  | \$ 1,377,111                                      | \$ 1,253,729 |
| Ceded  | (320,027)   | (291,074)    |
| Net  | \$ 1,057,084                                      | \$ 962,655   |

For the first nine months of 2018, incurred losses and LAE included \$38.5 million of favorable development on prior years' loss reserves. The majority of products experienced modest amounts of favorable development on prior accident years, with notable contributions from commercial and personal umbrella, general liability, marine and surety. Executive products, transportation and medical professional liability were exceptions, experiencing adverse development.

For the first nine months of 2017, incurred losses and LAE included \$36.6 million of favorable development on prior years' loss reserves. Commercial umbrella, general liability, surety and marine were drivers of the favorable development, while adverse experience in transportation and medical professional liability partially offset the result.

## 5. INCOME TAXES

Our effective tax rate for the three and nine-month periods ended September 30, 2018 was 15.1 percent and 15.4 percent. Catastrophic losses incurred in the third quarter of 2017 resulted in a pretax loss and a 301.2 percent effective tax rate for the third quarter and a 19.9 percent effective rate for the nine-month period ended September 30, 2017. The Tax Cuts and Jobs Act of 2017 (TCJA) lowered the federal corporate tax rate from 35 percent to 21 percent effective January 1, 2018, which accounts for the majority of the decrease in effective tax rate for the nine-month period over the prior year. Effective rates are also dependent upon components of pretax earnings and the related tax effects. Tax favored investment activity was lower in 2018, which resulted in a lower spread between the corporate rate and effective rate when compared to 2017. There have been no changes to the provisional amounts that we recorded in the fourth quarter of 2017 associated with the TCJA, as guidance has not yet been finalized by the Internal Revenue Service. Accounting for the tax effects of the enactment of the TCJA will be completed in the fourth quarter of 2018.

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Income tax expense attributable to income from operations for the three and nine-month periods ended September 30, 2018 and 2017 differed from the amounts computed by applying the U.S. federal tax rate of 21 percent and 35 percent, respectively, to pretax income by the items detailed in the below table. In interim periods, income taxes are adjusted to reflect the effective tax rate we anticipate for the year, with adjustments flowing through the other items line.

| (in thousands)  | For the Three-Month Periods Ended September 30, 2018 |         |             |          | For the Nine-Month Periods Ended September 30, 2018 |         |             |         |
|---|--|---------|-------------|----------|---|---------|-------------|---------|
|   | Amount   | %       | 2017 Amount | %        | Amount  | %       | 2017 Amount | %       |
| Provision for income taxes at the statutory rate of 21% in 2018 and 35% in 2017 | \$ 9,733   | 21.0 %  | \$ (302)    | 35.0 %   | \$ 21,061   | 21.0 %  | \$ 20,866   | 35.0 %  |
| Increase (reduction) in taxes resulting from:                                   |  |         |             |          |   |         |             |         |
| Excess tax benefit on share-based compensation                                  | (2,273)  | (4.9) % | (477)       | 55.3 %   | (4,340)   | (4.3) % | (3,711)     | (6.2) % |
| Tax exempt interest income  | (375)  | (0.8) % | (1,187)     | 137.7 %  | (1,460)   | (1.5) % | (3,525)     | (5.9) % |
| Dividends received deduction  | (150)  | (0.3) % | (553)       | 64.2 %   | (516)   | (0.5) % | (1,488)     | (2.5) % |
| ESOP dividends paid deduction   | (139)  | (0.3) % | (240)       | 27.9 %   | (423)   | (0.4) % | (724)       | (1.2) % |
| Other items, net  | 181  | 0.4 %   | 163         | (18.9) % | 1,128   | 1.1 %   | 429         | 0.7 %   |
| Total tax expense (benefit)   | \$ 6,977   | 15.1 %  | \$ (2,596)  | 301.2 %  | \$ 15,450   | 15.4 %  | \$ 11,847   | 19.9 %  |

## 6. STOCK BASED COMPENSATION

Our RLI Corp. Omnibus Stock Plan (omnibus plan) was in place from 2005 to 2010. The omnibus plan provided for equity-based compensation, including stock options, up to a maximum of 3,000,000 shares of common stock (subject to adjustment for changes in our capitalization and other events). Between 2005 and 2010, we granted 2,458,059 stock options under this plan, including incentive stock options (ISOs), which were adjusted as part of the special dividends paid in 2014 and prior years. The omnibus plan was replaced in 2010.

In 2010, our shareholders approved the RLI Corp. Long-Term Incentive Plan (2010 LTIP), which provides for equity-based compensation and replaced the omnibus plan. In conjunction with the adoption of the 2010 LTIP, effective May 6, 2010, options were no longer granted under the omnibus plan. The 2010 LTIP provided for equity-based compensation, including stock options, up to a maximum of 4,000,000 shares of common stock (subject to adjustment for changes in our capitalization and other events). Between 2010 and 2015, we granted 2,878,000 stock options under the 2010 LTIP. The 2010 LTIP was replaced in 2015.

In 2015, our shareholders approved the 2015 RLI Corp. Long-Term Incentive Plan (2015 LTIP), which provides for equity-based compensation and replaced the 2010 LTIP. In conjunction with the adoption of the 2015 LTIP, effective May 7, 2015, options were no longer granted under the 2010 LTIP. Awards under the 2015 LTIP may be in the form of restricted stock, restricted stock units, stock options (non-qualified only), stock appreciation rights, performance units as well as other stock-based awards. Eligibility under the 2015 LTIP is limited to employees and directors of the company or any affiliate. The granting of awards under the 2015 LTIP is solely at the discretion of the board of directors. The maximum number of shares of common stock available for distribution under the 2015 LTIP is 4,000,000 shares (subject to adjustment for changes in our capitalization and other events). Since 2015, we have granted 1,872,880 awards under the 2015 LTIP, including 424,305 thus far in 2018.

## Stock Options

Under the 2015 LTIP, as under the 2010 LTIP and 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 (subject to adjustments for changes in our capitalization, special dividends and other events as set forth in such plans). Options generally vest and become exercisable ratably over a five-year period and expire eight years after grant.

For most participants, 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

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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, 2018 and 2017:

|   | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in 000's) |
|---|-------------------------------------|--|---|---|
| Outstanding options at January 1, 2018    | 2,257,015                           | \$ 46.80                                 |   |   |
| Options granted                           | 401,250                             | \$ 64.31                                 |   |   |
| Options exercised                         | (685,810)                           | \$ 36.72                                 |   | \$ 23,603                                     |
| Options canceled/forfeited                | (15,600)                            | \$ 61.44                                 |   |   |
| Outstanding options at September 30, 2018 | 1,956,855                           | \$ 53.81                                 | 5.50  | \$ 48,476                                     |
| Exercisable options at September 30, 2018 | 678,905                             | \$ 45.60                                 | 4.03  | \$ 22,388                                     |

|   | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in 000's) |
|---|-------------------------------------|--|---|---|
| Outstanding options at January 1, 2017    | 2,207,110                           | \$ 40.90                                 |   |   |
| Options granted                           | 442,625                             | \$ 56.97                                 |   |   |
| Options exercised                         | (174,890)                           | \$ 25.27                                 |   | \$ 5,655                                      |
| Options canceled/forfeited                | (41,600)                            | \$ 48.30                                 |   |   |
| Outstanding options at September 30, 2017 | 2,433,245                           | \$ 44.82                                 | 4.84  | \$ 33,290                                     |
| Exercisable options at September 30, 2017 | 1,157,785                           | \$ 36.30                                 | 3.26  | \$ 25,078                                     |

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

Thus far in 2018, 401,250 stock options were granted with a weighted average exercise price of \$64.31 and a weighted average fair value of \$10.38. We recognized \$1.2 million of expense in the third quarter of 2018 and \$3.4 million in the first nine months of 2018 related to options vesting. Since options granted under our 2010 LTIP and 2015 LTIP are non-qualified, we recorded a tax benefit of \$0.2 million in the third quarter of 2018 and \$0.7 million in the first nine months of 2018 related to this compensation expense. Total unrecognized compensation expense relating to

outstanding and unvested options was \$6.2 million, which will be recognized over the remainder of the vesting period. Comparatively, we recognized \$1.0 million of expense in the third quarter of 2017 and \$3.0 million in the first nine months of 2017. We recorded a tax benefit of \$0.3 million in the third quarter of 2017 and \$1.1 million in the first nine months of 2017 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:

|                                       | 2018       | 2017       |
|---------------------------------------|------------|------------|
| Weighted-average fair value of grants | \$ 10.38   | \$ 7.95    |
| Risk-free interest rates              | 2.69 %     | 1.89 %     |
| Dividend yield                        | 3.15 %     | 3.60 %     |
| Expected volatility                   | 22.88 %    | 22.95 %    |
| Expected option life                  | 5.06 years | 5.05 years |

The risk-free rate was determined based on U.S. treasury yields that most closely approximated the option's expected life. The dividend yield was determined based on the average annualized quarterly dividends paid during the most recent five-year period and incorporated a consideration for special dividends paid in recent history. The expected volatility was calculated based



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on the median of the rolling volatilities for the expected life of the options. The expected option life was 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.

Restricted Stock Units

In addition to stock options, restricted stock units (RSUs) are granted with a value equal to the closing stock price of the Company’s stock on the dates the shares are granted. Generally, these units have a three-year cliff vesting. When participants terminate employment with the Company after having met the definition of retirement under the 2015 LTIP, defined as those individuals whose age and years of service equals 75, the RSUs will become fully vested. In addition, the RSUs have dividend participation which accrues and is settled in additional shares with all granted stock units at the end of the three-year period.

As of September 30, 2018, 30,075 RSUs have been granted to employees under the 2015 LTIP, including 14,625 during 2018, and 29,325 remain outstanding. We recognized \$0.2 million of expense on these units in the third quarter of 2018 and \$0.4 million in the first nine months of 2018. Total unrecognized compensation expense relating to outstanding and unvested RSUs was \$0.9 million, which will be recognized over the remainder of the vesting period. Comparatively, we recognized \$0.1 million of expense in the third quarter of 2017 and \$0.3 million in the first nine months of 2017 related to this compensation expense.

In 2018, each outside director received restricted stock units with a fair market value of \$50,000 on the date of grant as part of annual director compensation. A total of 8,430 restricted stock units were granted from the 2015 LTIP and vest one year from the date of grant. We recognized \$0.1 million of compensation expense on these units in the third quarter of 2018 and \$0.2 million in the first nine months of 2018. Total unrecognized compensation expense relating to outstanding and unvested director RSUs was \$0.3 million, which will be recognized over the remainder of the vesting period.

7. 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.

|          | For the Three-Month Periods<br>Ended September 30, | For the Nine-Month Periods<br>Ended September 30, |
|----------|--|---|
| REVENUES |  |   |

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| (in thousands)                                     | 2018       | 2017       | 2018       | 2017       |
|--|------------|------------|------------|------------|
| Casualty   | \$ 131,605 | \$ 118,393 | \$ 387,068 | \$ 354,636 |
| Property   | 39,067     | 33,559     | 111,439    | 103,849    |
| Surety   | 30,143     | 30,073     | 88,857     | 91,156     |
| Net premiums earned                                | \$ 200,815 | \$ 182,025 | \$ 587,364 | \$ 549,641 |
| Net investment income                              | 16,314     | 14,187     | 45,123     | 40,430     |
| Net realized gains (losses)                        | 18,647     | 35         | 47,900     | (700)      |
| Net unrealized gains (losses) on equity securities | 4,848      | -          | (34,535)   | -          |
| Total consolidated revenue                         | \$ 240,624 | \$ 196,247 | \$ 645,852 | \$ 589,371 |

NET EARNINGS

| (in thousands)                                     | 2018       | 2017        | 2018       | 2017      |
|--|------------|-------------|------------|-----------|
| Casualty   | \$ (1,974) | \$ 3,554    | \$ 2,441   | \$ 5,321  |
| Property   | 2,621      | (27,519)    | 12,150     | (15,852)  |
| Surety   | 7,115      | 9,033       | 24,804     | 28,399    |
| Net underwriting income                            | \$ 7,762   | \$ (14,932) | \$ 39,395  | \$ 17,868 |
| Net investment income                              | 16,314     | 14,187      | 45,123     | 40,430    |
| Net realized gains (losses)                        | 18,647     | 35          | 47,900     | (700)     |
| Net unrealized gains (losses) on equity securities | 4,848      | -           | (34,535)   | -         |
| General corporate expense and interest on debt     | (4,809)    | (3,812)     | (13,447)   | (13,385)  |
| Equity in earnings of unconsolidated investees     | 3,587      | 3,660       | 15,853     | 15,404    |
| Total earnings (loss) before income taxes          | \$ 46,349  | \$ (862)    | \$ 100,289 | \$ 59,617 |
| Income tax expense (benefit)                       | 6,977      | (2,596)     | 15,450     | 11,847    |
| Total net earnings                                 | \$ 39,372  | \$ 1,734    | \$ 84,839  | \$ 47,770 |

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The following table further summarizes revenues by major product type within each operating segment:

| NET PREMIUMS EARNED<br>(in thousands) | For the Three-Month Periods<br>Ended September 30, |            | For the Nine-Month Periods<br>Ended September 30, |            |
|---------------------------------------|--|------------|---|------------|
|                                       | 2018   | 2017       | 2018  | 2017       |
| Casualty                              |  |            |   |            |
| Commercial and personal umbrella      | \$ 31,244  | \$ 28,848  | \$ 91,845   | \$ 86,286  |
| General liability                     | 22,485   | 22,138     | 68,988  | 66,572     |
| Commercial transportation             | 20,747   | 18,047     | 60,570  | 59,543     |
| Professional services                 | 19,890   | 19,584     | 59,559  | 58,826     |
| Small commercial                      | 12,883   | 12,419     | 38,674  | 36,471     |
| Executive products                    | 5,352  | 4,439      | 15,548  | 13,289     |
| Medical professional liability        | 3,988  | 4,169      | 12,822  | 12,725     |
| Other casualty                        | 15,016   | 8,749      | 39,062  | 20,924     |
| Total                                 | \$ 131,605   | \$ 118,393 | \$ 387,068  | \$ 354,636 |
| Property                              |  |            |   |            |
| Commercial property                   | \$ 18,489  | \$ 15,600  | \$ 53,296   | \$ 47,191  |
| Marine                                | 16,068   | 13,112     | 44,866  | 37,005     |
| Specialty personal                    | 4,228  | 4,844      | 12,499  | 16,370     |
| Property reinsurance                  | 13   | (62)       | 39  | 3,200      |
| Other property                        | 269  | 65         | 739   | 83         |
| Total                                 | \$ 39,067  | \$ 33,559  | \$ 111,439  | \$ 103,849 |
| Surety                                |  |            |   |            |
| Miscellaneous                         | \$ 11,822  | \$ 11,780  | \$ 35,183   | \$ 35,491  |
| Contract                              | 7,474  | 7,130      | 20,832  | 21,361     |
| Commercial                            | 6,863  | 6,861      | 20,337  | 20,942     |
| Energy                                | 3,984  | 4,302      | 12,505  | 13,362     |
| Total                                 | \$ 30,143  | \$ 30,073  | \$ 88,857   | \$ 91,156  |
| Grand Total                           | \$ 200,815   | \$ 182,025 | \$ 587,364  | \$ 549,641 |

## 8. CONTINGENT LIABILITIES

Carriage Hill Associates Coverage Dispute

As reported in the Company's Form 10-Q filed for the second quarter of 2018, Carriage Hill Associates of Charleston, LLC and certain other plaintiffs (collectively, "Plaintiffs") filed a complaint in the Court of Common Pleas (the "Court") for the Ninth Judicial Circuit of Berkeley County, South Carolina in December 2010 against Mt. Hawley Insurance Company ("Mt. Hawley"), a subsidiary of our principal subsidiary, RLI Insurance Company, relating to a coverage dispute. The complaint seeks, among other things, compensatory damages, punitive damages and attorneys' fees.

On May 25, 2018, the Court issued an Order finding in favor of Plaintiffs (the "Order"). The Court held that Mt. Hawley was responsible for compensatory damages relating to the alleged breach of duty to defend, breach of duty to indemnify and breach of duty of good faith totaling \$21.7 million. The Court further held that Plaintiffs are entitled to attorneys' fees and costs and that punitive damages are appropriate, with a hearing to be conducted at a later date to determine the amount of attorney fees and costs, and punitive damages.

Mt. Hawley vigorously contested all the claims against it in this matter and filed certain post-trial motions seeking to, among other things, withdraw and vacate the Order. As the result of Court-recommended mediation between the parties, all of the claims in this matter among all parties have been settled on a confidential basis for an amount that did not have a material impact on the Company's financial statements. Upon payment of the agreed-upon settlement amount, it is expected that the Order will be vacated and the matter will be dismissed with prejudice.

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9. SUBSEQUENT EVENTS

In early October 2018, Hurricane Michael made landfall in Florida as a Category 4 storm and traveled through the southeastern states. It is too early to estimate the amount of losses that will be incurred from this event and the impact will be reflected in our fourth quarter 2018 results.

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, 2017.

OVERVIEW

RLI Corp. (the “Company”) is an insurance holding company that was organized in 1965. On May 4, 2018, RLI Corp. changed its state of incorporation from the State of Illinois to the State of Delaware. For more information on the reincorporation, see note 1.A to the unaudited condensed consolidated interim financial statements. 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 (RLI Ins.), a subsidiary of RLI Corp. and our principal insurance subsidiary, writes multiple lines of insurance on an admitted basis in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. Mt. Hawley Insurance Company (Mt. Hawley), a subsidiary of RLI Ins., writes excess and surplus lines insurance on a non-admitted basis in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. Contractors Bonding and Insurance Company (CBIC), a subsidiary of RLI Ins., writes multiple lines of insurance on an admitted basis in all 50 states and the District of Columbia. Each of our insurance companies is domiciled in Illinois.

As a specialty insurance company with a niche focus, we offer insurance coverages in both the specialty admitted and excess and surplus markets. Coverages in the specialty admitted market, such as our energy surety bonds, are for risks that are unique or hard-to-place in the standard market, but must remain with an admitted insurance company for regulatory or marketing reasons. In addition, our coverages in the specialty admitted market may be designed to meet specific insurance needs of targeted insured groups, such as our professional liability and package coverages for design professionals and our stand-alone personal umbrella policy. The specialty admitted market is subject to more state regulation than the excess and surplus market, particularly with regard to rate and form filing requirements,

restrictions on the ability to exit lines of business, premium tax payments and membership in various state associations, such as state guaranty funds and assigned risk plans. We also underwrite coverages in the excess and surplus market. The excess and surplus market, unlike the admitted market, is less regulated and more flexible in terms of policy forms and premium rates. This market provides an alternative for customers with risks or loss exposures that generally cannot be written in the standard market. This typically results in coverages that are more restrictive and more expensive than coverages in the admitted market. When we underwrite within the excess and surplus market, we are selective in the lines of business and type of risks we choose to write. Using our non-admitted status in this market allows us to tailor terms and conditions to manage these exposures effectively. Often, the development of these coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients or loss exposures. Once a proposal is submitted, our underwriters determine whether it would be a viable product based on our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all market conditions and we have achieved this for 22 consecutive years, averaging an 87.8 combined ratio over that period of time. This drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly-rated, diversified, liquid, investment-grade securities. Consistent underwriting income allows a portion of our investment portfolio to be invested in equity securities and other risk asset classes. Our equity portfolio consists of a core stock portfolio weighted toward dividend-paying stocks, as well as exchange traded funds (ETFs). Our minority equity ownership interests in Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality sunglasses, and Prime Holdings Insurance Services, Inc. (Prime), a specialty insurance company, has also enhanced financial results. We have a diversified investment portfolio and closely monitor our

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investment risks. Despite periodic fluctuations in market value, our equity portfolio is part of a long-term asset allocation strategy and has contributed significantly to our historic growth in book value.

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

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

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

The casualty portion of our business consists largely of commercial umbrella, personal umbrella, general liability, transportation and executive products coverages, as well as package business and other specialty coverages, such as professional liability and workers' compensation for office-based professionals. We also offer fidelity and crime coverage for commercial insureds and select financial institutions and medical and healthcare professional liability 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 is comprised primarily of commercial fire, earthquake, difference in conditions and marine coverages. We also offer select personal lines policies, including homeowners' coverages. Our property reinsurance and recreational vehicle products are in runoff after we began curtailing offerings at the end of 2015 and 2016, respectively. 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 wind storms to commercial properties throughout the Gulf and East Coast, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by minimizing the total policy limits written in a particular region, purchasing reinsurance and maintaining policy terms and conditions throughout market cycles. We also use computer-assisted modeling techniques to provide estimates that help us carefully manage the concentration of risks exposed to catastrophic events.

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

The insurance marketplace is intensely competitive across all of our segments. Despite challenges that exist in today's marketplace, we believe that our business model is built to create underwriting income by focusing on sound risk selection and discipline. Our primary focus will continue to be on underwriting profitability, with a secondary focus on premium growth where we believe underwriting profit exists, as opposed to general premium growth or market share measurements.

#### GAAP, non-GAAP and Performance Measures

Throughout this quarterly report, we include certain non-generally accepted accounting principles ("non-GAAP") financial measures. Management believes that these non-GAAP measures better explain the Company's results of operations and allow for a more complete understanding of the underlying trends in the Company's business. These measures should not be viewed as a substitute for those determined in accordance with generally accepted accounting principles in the United States



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of America (GAAP). In addition, our definitions of these items may not be comparable to the definitions used by other companies.

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

### Underwriting Income

Underwriting income or profit represents one measure of the pretax profitability of our insurance operations and is derived by subtracting losses and settlement expenses, policy acquisition costs and insurance operating expenses from net premiums earned, which are all GAAP financial measures. Each of these captions is presented in the statements of earnings but is not subtotaled. However, this information is available in total and by segment in note 11 to the consolidated financial statements in our 2017 Annual Report on Form 10-K, regarding operating segment information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains or losses, net unrealized gain or losses on equity securities in 2018, general corporate expenses, debt costs and our portion of earnings from unconsolidated investees.

### Combined Ratio

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

### Net Unpaid Loss and Settlement Expenses

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

the process of establishing these various estimated amounts.

### Critical Accounting Policies

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

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation and OTTI, recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes. For a detailed discussion of each of these policies, refer to our 2017 Annual Report on Form 10-K. There have been no significant changes to any of these policies during the current year.

### RESULTS OF OPERATIONS

#### Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017

Consolidated revenue for the first nine months of 2018 increased \$56.5 million, or 10 percent, from the same period in 2017. Net premiums earned for the Group increased 7 percent, driven by growth from our casualty and property segments, while investment income increased 12 percent due to an increased asset base and rising interest rates. Realized gains during the first nine months of 2018 were \$47.9 million, compared to \$0.7 million of realized losses during the same period of 2017. The 2018 gain was comprised of \$52.5 million of realized gains on equity securities from rebalancing the portfolio, \$0.1 million of realized losses on the fixed income portfolio and \$4.6 million in miscellaneous losses, primarily from a non-cash impairment

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charge on goodwill and definite-lived intangible assets. This compares to realized gains of \$5.0 million on equity securities, \$1.6 million of losses on the fixed income portfolio and a \$3.4 million non-cash impairment charge on goodwill and definite-lived intangible assets in 2017. These increases were partially offset by the \$34.5 million of net unrealized losses on equity securities, which are required to be recognized in earnings for 2018 and forward due to the adoption of ASU 2016-01. Prior to 2018, unrealized gains and losses on equity securities were recognized through other comprehensive earnings.

|  | For the Nine-Month Periods<br>Ended September 30, |            |
|--|---|------------|
|  | 2018  | 2017       |
| Consolidated revenues (in thousands)               |   |            |
| Net premiums earned                                | \$ 587,364  | \$ 549,641 |
| Net investment income                              | 45,123  | 40,430     |
| Net realized gains (losses)                        | 47,900  | (700)      |
| Net unrealized gains (losses) on equity securities | (34,535)  | -          |
| Total consolidated revenue                         | \$ 645,852  | \$ 589,371 |

Net after-tax earnings for the first nine months of 2018 totaled \$84.8 million, compared to \$47.8 million for the same period last year. The increased earnings for 2018 were largely the result of reduced catastrophe activity compared to the prior year. Hurricane, other storm losses and volcanic activity in Hawaii totaled \$17.5 million through the first nine months of 2018. Comparatively, \$39.0 million of hurricane and storm losses were incurred during the same period in 2017. After-tax realized and unrealized gains (losses) on equity securities totaled \$14.4 million and contributed to the overall increase in earnings along with the larger amount of net investment income. Underwriting results for both periods reflect favorable development from prior years' loss reserves. Favorable development on prior years' loss reserves provided additional pretax earnings of \$38.5 million in the first nine months of 2018 compared to \$36.6 million in 2017. Bonus and profit sharing-related expenses associated with the net impact of prior years' reserve development and catastrophe losses totaled \$3.5 million in 2018, compared to \$0.2 million in 2017. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonus and profit-sharing amounts earned by executives, managers and associates are predominately influenced by corporate performance including operating earnings, combined ratio and return on capital.

During the first nine months of 2018, equity in earnings of unconsolidated investees totaled \$15.9 million. This amount includes \$13.3 million from Maui Jim and \$2.6 million from Prime. Comparatively, the first nine months of 2017 reflected \$15.4 million of earnings, including \$13.6 million from Maui Jim and \$1.8 million from Prime. In addition, net earnings for the nine-month period benefited from a lower effective tax rate, 15 percent in 2018 compared to 20 percent in 2017, resulting from the Tax Cuts and Jobs Act of 2017 (TCJA), which reduced the corporate tax rate from 35 percent to 21 percent beginning January 1, 2018.

Comprehensive earnings totaled \$43.1 million for the first nine months of 2018, compared to \$78.6 million for the first nine months of 2017. Other comprehensive earnings primarily included after-tax unrealized gains and losses from the fixed income portfolio in 2018 and after-tax unrealized gains and losses from both the fixed income and equity

portfolios in 2017. The \$41.8 million of other comprehensive loss in the first nine months of 2018 was due to unrealized losses on the fixed income portfolio as interest rates increased. This compares to \$30.8 million of other comprehensive earnings for the same period in 2017, as equity market returns were strong and interest rates declined slightly.

#### RLI Insurance Group

Gross premiums written for the Group increased 11 percent to \$725.8 million for the first nine months of 2018. The majority of our products contributed to growth in the period, with the bulk of the increase driven by products in our casualty and property segments. Net premiums earned increased \$37.7 million, or 7 percent, also driven by products in our casualty and property segments.

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| (in thousands)                          | Gross Premiums Written<br>For the Nine-Month Periods<br>Ended September 30, |                   |             |          | Net Premiums Earned<br>For the Nine-Month Periods<br>Ended September 30, |                   |              |          |
|---|---|-------------------|-------------|----------|--|-------------------|--------------|----------|
|   | 2018  | 2017              | % Change    |          | 2018   | 2017              | % Change     |          |
| <b>Casualty</b>                         |   |                   |             |          |  |                   |              |          |
| <b>Commercial and personal umbrella</b> |   |                   |             |          |  |                   |              |          |
|   | \$ 116,116  | \$ 103,456        | 12.2        | %        | \$ 91,845  | \$ 86,286         | 6.4          | %        |
| General liability                       | 69,516  | 69,326            | 0.3         | %        | 68,988   | 66,572            | 3.6          | %        |
| Commercial transportation               | 72,639  | 67,006            | 8.4         | %        | 60,570   | 59,543            | 1.7          | %        |
| Professional services                   | 66,265  | 64,179            | 3.3         | %        | 59,559   | 58,826            | 1.2          | %        |
| Small commercial                        | 41,197  | 40,838            | 0.9         | %        | 38,674   | 36,471            | 6.0          | %        |
| Executive products                      | 45,865  | 37,185            | 23.3        | %        | 15,548   | 13,289            | 17.0         | %        |
| Medical professional liability          | 14,807  | 16,392            | (9.7)       | %        | 12,822   | 12,725            | 0.8          | %        |
| Other casualty                          | 50,124  | 33,492            | 49.7        | %        | 39,062   | 20,924            | 86.7         | %        |
| <b>Total</b>                            | <b>\$ 476,529</b>   | <b>\$ 431,874</b> | <b>10.3</b> | <b>%</b> | <b>\$ 387,068</b>  | <b>\$ 354,636</b> | <b>9.1</b>   | <b>%</b> |
| <b>Property</b>                         |   |                   |             |          |  |                   |              |          |
| <b>Commercial property</b>              |   |                   |             |          |  |                   |              |          |
|   | \$ 85,884   | \$ 71,351         | 20.4        | %        | \$ 53,296  | \$ 47,191         | 12.9         | %        |
| Marine                                  | 54,145  | 45,921            | 17.9        | %        | 44,866   | 37,005            | 21.2         | %        |
| Specialty personal                      | 14,024  | 13,565            | 3.4         | %        | 12,499   | 16,370            | (23.6)       | %        |
| Property reinsurance                    | 36  | 414               | (91.3)      | %        | 39   | 3,200             | (98.8)       | %        |
| Other property                          | 1,006   | 540               | -           |          | 739  | 83                | -            |          |
| <b>Total</b>                            | <b>\$ 155,095</b>   | <b>\$ 131,791</b> | <b>17.7</b> | <b>%</b> | <b>\$ 111,439</b>  | <b>\$ 103,849</b> | <b>7.3</b>   | <b>%</b> |
| <b>Surety</b>                           |   |                   |             |          |  |                   |              |          |
| <b>Miscellaneous</b>                    |   |                   |             |          |  |                   |              |          |
|   | \$ 37,680   | \$ 36,133         | 4.3         | %        | \$ 35,183  | \$ 35,491         | (0.9)        | %        |
| Contract                                | 23,320  | 22,326            | 4.5         | %        | 20,832   | 21,361            | (2.5)        | %        |
| Commercial                              | 20,956  | 21,477            | (2.4)       | %        | 20,337   | 20,942            | (2.9)        | %        |
| Energy                                  | 12,233  | 12,646            | (3.3)       | %        | 12,505   | 13,362            | (6.4)        | %        |
| <b>Total</b>                            | <b>\$ 94,189</b>  | <b>\$ 92,582</b>  | <b>1.7</b>  | <b>%</b> | <b>\$ 88,857</b>   | <b>\$ 91,156</b>  | <b>(2.5)</b> | <b>%</b> |
| <b>Grand Total</b>                      | <b>\$ 725,813</b>   | <b>\$ 656,247</b> | <b>10.6</b> | <b>%</b> | <b>\$ 587,364</b>  | <b>\$ 549,641</b> | <b>6.9</b>   | <b>%</b> |

**Casualty**

Gross premiums written for the casualty segment in the first nine months of 2018 were up 10 percent, or \$44.7 million, as most products posted top line growth. Growth was led by other casualty, which includes general binding authority coverages and assumed reinsurance business with Prime. Gross premiums written for Prime have continued to grow, up 32 percent for the first nine months. The general binding authority business was launched at the beginning of 2017 and grew its top line by \$5.3 million in the first nine months of 2018 when compared to the same period in 2017. New products, rate increases and exposure growth led to an additional \$12.7 million of premium for commercial and personal umbrella. Our executive products group made significant contributions, with both mature and newer product offerings, such as cyber liability coverages, exhibiting growth. Premiums for commercial transportation increased \$5.6 million, driven by both exposure growth and rate increases. The overall rate for

commercial transportation was up 9 percent, after increasing by approximately the same amount in 2017. Medical professional liability decreased \$1.6 million due to intensifying competition.

## Property

Gross premiums written for the Group's property segment were up \$23.3 million for the first nine months of 2018 from the same period last year. The bulk of the growth was attributable to commercial property, which was up 20 percent, primarily as a result of exposure growth. However, renewal rates for catastrophe prone wind exposures have improved since the hurricane activity in the third quarter of 2017. Our marine business was up 18 percent over the prior year due largely to exposure growth, though pricing has also improved slightly. Production from our specialty personal lines reflect increased performance from our Hawaii homeowners' product, up 10 percent, but declined in total because of our previously announced exit from recreational vehicles.

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## Surety

The surety segment recorded gross premiums written of \$94.2 million for the first nine months of 2018, an increase of \$1.6 million from the same period last year. An improving construction market and targeted initiatives aided growth in our contract and miscellaneous lines. However, challenging market conditions and the industry's consolidation of accounts impacted the production of our commercial and energy surety lines which were down from the prior year.

## RLI Insurance Group

Underwriting income for the Group totaled \$39.4 million for the first nine months of 2018, compared to \$17.9 million in the same period last year. Catastrophe losses had a larger impact in 2017, as a result of Hurricanes Harvey, Irma and Maria. Total catastrophe losses, net of related bonus and profit sharing expense offsets, was \$14.9 million for 2018, compared to \$34.2 million in 2017. Both years reflect favorable development on prior years' loss reserves, though the benefit was larger in 2018. The combined ratio for the Group totaled 93.3 in 2018, compared to 96.7 in 2017. The loss ratio decreased to 51.8 from 55.8 and the Group's expense ratio increased to 41.5 from 40.9.

|                                    | For the Nine-Month<br>Periods<br>Ended September 30, |           |
|------------------------------------|--|-----------|
|                                    | 2018   | 2017      |
| Underwriting income (in thousands) |  |           |
| Casualty                           | \$ 2,441   | \$ 5,321  |
| Property                           | 12,150   | (15,852)  |
| Surety                             | 24,804   | 28,399    |
| Total                              | \$ 39,395  | \$ 17,868 |
| Combined ratio                     |  |           |
| Casualty                           | 99.4   | 98.5      |
| Property                           | 89.1   | 115.3     |
| Surety                             | 72.1   | 68.8      |
| Total                              | 93.3   | 96.7      |

## Casualty

The casualty segment recorded underwriting income of \$2.4 million in the first nine months of 2018, compared to \$5.3 million for the same period last year. The reduction of underwriting profit relates, in part, to a shift in business mix, as well as to our cautious approach to reserving for losses on newer products and the higher expense ratio

associated with starting those lines. As a result, both the current accident year loss and expense ratios have increased. Partially offsetting these impacts was increased favorable development on prior accident years, which improved net underwriting results for the casualty segment by \$20.2 million in the first nine months of 2018, primarily on accident years 2015 through 2017. Notable contributions toward this favorable development were from umbrella, general liability and professional services, while executive products and transportation developed adversely. In comparison, \$16.5 million of reserves were released in the first nine months of 2017, related to umbrella, general liability, executive products, small commercial and professional services, while transportation and medical professional liability experienced unfavorable development.

The combined ratio for the casualty segment was 99.4 for 2018, compared to 98.5 in 2017. The segment's loss ratio was 63.7 in 2018, down from 64.0 in 2017. The loss ratio decrease in 2018 was driven by the higher favorable development on prior years' reserves, despite a slightly higher current accident year loss ratio compared to 2017. The expense ratio for the casualty segment was 35.7, up from 34.5 for the same period last year, due to new business initiatives, investments in technology and a modest shift in mix towards products with higher acquisition rates.

#### Property

The property segment recorded underwriting income of \$12.2 million for the first nine months of 2018, compared to an underwriting loss of \$15.9 million for the same period last year. The loss in 2017 was the result of an active hurricane season, as total catastrophe losses reduced net underwriting earnings by \$31.8 million in the first nine months of 2017. Comparatively, catastrophe losses impacted net underwriting results for 2018 by \$15.9 million, as a result of Hurricane Florence, other storms and volcanic activity in Hawaii. Underwriting results for 2018 included \$6.1 million of net favorable development on prior



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years' loss reserves, primarily from the marine and commercial property businesses, while 2017 included \$5.8 million of net favorable development on prior years' loss reserves, also primarily from the marine and commercial property businesses.

Underwriting results for the first nine months of 2018 translated into a combined ratio of 89.1, compared to 115.3 for the same period last year. The segment's loss ratio was 45.2 in 2018, down from 69.4 in 2017 due to higher levels of catastrophe losses in the prior year. The segment's expense ratio decreased to 43.9 in 2018 from 45.9 in the prior year, due in part to the fixed nature of certain expenses and an increase in earned premium.

Surety

The surety segment recorded underwriting income of \$24.8 million for the first nine months of 2018, compared to \$28.4 million for the same period last year. Both periods reflected positive current accident year underwriting performance and benefited from favorable development on prior years' loss reserves. Results for 2018 included favorable development on prior accident years' reserves across all surety lines, which improved net underwriting results for the segment by \$9.2 million. Comparatively, 2017 results included favorable development on prior accident years' loss reserves across all products, which improved the segment's net underwriting results by \$10.8 million.

The combined ratio for the surety segment totaled 72.1 for the first nine months of 2018, compared to 68.8 for the same period in 2017. The segment's loss ratio was 8.5 for both periods. The expense ratio was 63.6, up from 60.3 in the prior year, due to a modest decline in earned premium, increased investments in technology and a modest shift in mix towards miscellaneous surety, which has higher acquisition rates than some other lines.

Investment Income and Realized Capital Gains

Our investment portfolio generated net investment income of \$45.1 million during the first nine months of 2018, an increase of 11.6 percent from that reported for the same period in 2017. The increase in investment income was due to an increased asset base and rising interest rates compared to the prior year period. On an after-tax basis, investment income increased by 19.9 percent, as lower tax rates also benefited income in 2018.

Yields on our fixed income investments for the first nine months of 2018 and 2017 were as follows:

|                 | 2018 |   | 2017 |   |
|-----------------|------|---|------|---|
| Pretax Yield    |      |   |      |   |
| Taxable         | 3.27 | % | 3.17 | % |
| Tax-Exempt      | 2.70 | % | 2.57 | % |
| After-Tax Yield |      |   |      |   |
| Taxable         | 2.58 | % | 2.06 | % |
| Tax-Exempt      | 2.56 | % | 2.43 | % |

We recognized \$47.9 million of realized gains in the first nine months of 2018, compared to realized losses of \$0.7 million in the same period of 2017. Realized gains in the equity portfolio of \$52.5 million were partially offset by realized losses of \$0.1 million in the fixed income portfolio as well as realized losses related to a non-cash impairment charge on goodwill and definite-lived intangibles. Equity portfolio rebalancing accounts for the higher amount of gains compared to that realized in the previous year.

The following table depicts the composition of our investment portfolio at September 30, 2018 as compared to December 31, 2017.

| (in thousands)                  | 9/30/2018            |        | 12/31/2017           |        |
|---------------------------------|----------------------|--------|----------------------|--------|
|                                 | Financial Stmt Value | %      | Financial Stmt Value | %      |
| Fixed income                    | \$ 1,719,617         | 77.1 % | \$ 1,672,239         | 78.1 % |
| Equity securities               | 394,375              | 17.7 % | 400,492              | 18.7 % |
| Other invested assets           | 38,777               | 1.7 %  | 33,808               | 1.6 %  |
| Cash and short-term investments | 77,995               | 3.5 %  | 34,251               | 1.6 %  |
| Total                           | \$ 2,230,764         | 100.0% | \$ 2,140,790         | 100.0% |

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

The fixed income portfolio increased by \$47.4 million in the first nine months of 2018. The increase was primarily due to cash flows being allocated to the fixed income portfolio. Average fixed income duration was 4.7 years at September 30, 2018, reflecting our current liability structure and sound capital position. The equity portfolio decreased by \$6.1 million during the first nine months of 2018.

## Income Taxes

Our effective tax rate for the nine-month period ended September 30, 2018 was 15.4 percent, compared to 19.9 percent for the same period in 2017. The Tax Cuts and Jobs Act of 2017 (TCJA) lowered the federal corporate tax rate from 35 percent to 21 percent effective January 1, 2018, which accounts for the majority of the decrease in effective tax rate over the prior year. Effective rates are also dependent upon components of pretax earnings and the related tax effects. Tax favored investment activity was lower in 2018, which resulted in a lower spread between the corporate rate and effective rate when compared to 2017.

## Three Months Ended September 30, 2018 Compared to Three Months Ended September 30, 2017

Consolidated revenue for the third quarter of 2018 increased \$44.4 million, or 23 percent, from the same period in 2017. Net premiums earned for the Group increased 10 percent, driven by growth from our casualty and property segments, while investment income increased 15 percent due to an increased asset base and rising interest rates. Realized gains during the quarter were \$18.6 million and were comprised of \$18.0 million of realized gains on equity securities from rebalancing the portfolio and \$0.8 million of realized gains on the fixed income portfolio. This compares to realized gains of \$1.1 million on the equity portfolio that were offset by \$1.0 million of other realized losses in 2017. Additionally, \$4.8 million of net unrealized gains on equity securities were recognized in the third quarter of 2018 due to the adoption of ASU 2016-01. Prior to 2018, unrealized gains and losses on equity securities were recognized through other comprehensive earnings.

|                                      | For the Three-Month Periods<br>Ended September 30, |            |
|--------------------------------------|--|------------|
|                                      | 2018   | 2017       |
| Consolidated revenues (in thousands) |  |            |
| Net premiums earned                  | \$ 200,815   | \$ 182,025 |
| Net investment income                | 16,314   | 14,187     |
| Net realized gains (losses)          | 18,647   | 35         |

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|  |            |            |
|--|------------|------------|
| Net unrealized gains (losses) on equity securities | 4,848      | -          |
| Total consolidated revenue                         | \$ 240,624 | \$ 196,247 |

Net after-tax earnings for the third quarter of 2018 totaled \$39.4 million, compared to \$1.7 million for the same period last year. The increase in earnings for 2018 was largely attributable to the reduction in catastrophe activity over the prior year. Hurricane Florence resulted in \$7.5 million of catastrophe losses in the third quarter of 2018, compared to \$36.0 million of catastrophe losses from Hurricanes Harvey, Irma and Maria in 2017. An additional \$14.7 million of after tax realized gains, increased investment income of \$2.1 million and \$3.8 million of after tax unrealized gains on equity securities also contributed to the improved 2018 earnings. Underwriting results for both periods reflect favorable development from prior years' loss reserves. Favorable development on prior years' loss reserves provided additional pretax earnings of \$10.5 million in the third quarter of 2018 compared to \$17.0 million in 2017. Bonus and profit sharing-related expenses associated with the net impact of prior years' reserve development and catastrophe losses totaled \$0.6 million in 2018, compared to a \$2.3 million reduction of expenses in 2017. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonus and profit-sharing amounts earned by executives, managers and associates are predominately influenced by corporate performance including operating earnings, combined ratio and return on capital.

During the third quarter of 2018, equity in earnings of unconsolidated investees totaled \$3.6 million. This amount includes \$2.6 million from Maui Jim and \$1.0 million from Prime. Comparatively, the third quarter of 2017 reflected \$3.7 million of earnings, including \$3.1 million from Maui Jim and \$0.6 million from Prime.

Comprehensive earnings totaled \$31.7 million for the third quarter of 2018, compared to \$10.2 million for the third quarter of 2017. Other comprehensive earnings primarily included after-tax unrealized gains and losses from the fixed income portfolio in 2018 and after-tax unrealized gains and losses from both the fixed income and equity portfolios in 2017. The third

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quarter's \$7.7 million of other comprehensive loss was due to unrealized losses on the fixed income portfolio as interest rates increased. This compares to \$8.4 million of other comprehensive earnings for the same period in 2017, primarily attributable to strong equity market returns.

## RLI Insurance Group

Gross premiums written for the Group increased \$18.7 million, or 8 percent, for the third quarter of 2018 when compared to 2017. The majority of our products contributed to growth in the period, with the bulk of the increase driven by products in our casualty and property segments. Net premiums earned increased \$18.8 million, or 10 percent, also driven by products in our casualty and property segments.

| (in thousands)                   | Gross Premiums Written<br>For the Three-Month Periods<br>Ended September 30, |                   |              | Net Premiums Earned<br>For the Three-Month Periods<br>Ended September 30, |                   |                   |             |          |
|----------------------------------|--|-------------------|--------------|---|-------------------|-------------------|-------------|----------|
|                                  | 2018   | 2017              | % Change     | 2018  | 2017              | % Change          |             |          |
| <b>Casualty</b>                  |  |                   |              |   |                   |                   |             |          |
| Commercial and personal umbrella | \$ 39,589  | \$ 32,993         | 20.0         | %   | \$ 31,244         | \$ 28,848         | 8.3         | %        |
| General liability                | 20,021   | 18,384            | 8.9          | %   | 22,485            | 22,138            | 1.6         | %        |
| Commercial transportation        | 25,449   | 28,251            | (9.9)        | %   | 20,747            | 18,047            | 15.0        | %        |
| Professional services            | 21,754   | 21,162            | 2.8          | %   | 19,890            | 19,584            | 1.6         | %        |
| Small commercial                 | 13,178   | 13,102            | 0.6          | %   | 12,883            | 12,419            | 3.7         | %        |
| Executive products               | 16,340   | 14,621            | 11.8         | %   | 5,352             | 4,439             | 20.6        | %        |
| Medical professional liability   | 2,118  | 4,285             | (50.6)       | %   | 3,988             | 4,169             | (4.3)       | %        |
| Other casualty                   | 19,104   | 12,218            | 56.4         | %   | 15,016            | 8,749             | 71.6        | %        |
| <b>Total</b>                     | <b>\$ 157,553</b>  | <b>\$ 145,016</b> | <b>8.6</b>   | <b>%</b>  | <b>\$ 131,605</b> | <b>\$ 118,393</b> | <b>11.2</b> | <b>%</b> |
| <b>Property</b>                  |  |                   |              |   |                   |                   |             |          |
| Commercial property              | \$ 25,667  | \$ 23,315         | 10.1         | %   | \$ 18,489         | \$ 15,600         | 18.5        | %        |
| Marine                           | 19,765   | 16,770            | 17.9         | %   | 16,068            | 13,112            | 22.5        | %        |
| Specialty personal               | 5,066  | 4,382             | 15.6         | %   | 4,228             | 4,844             | (12.7)      | %        |
| Property reinsurance             | 13   | (201)             | -            |   | 13                | (62)              | -           |          |
| Other property                   | 422  | 347               | 21.6         | %   | 269               | 65                | 313.8       | %        |
| <b>Total</b>                     | <b>\$ 50,933</b>   | <b>\$ 44,613</b>  | <b>14.2</b>  | <b>%</b>  | <b>\$ 39,067</b>  | <b>\$ 33,559</b>  | <b>16.4</b> | <b>%</b> |
| <b>Surety</b>                    |  |                   |              |   |                   |                   |             |          |
| Miscellaneous                    | \$ 12,722  | \$ 12,149         | 4.7          | %   | \$ 11,822         | \$ 11,780         | 0.4         | %        |
| Contract                         | 7,677  | 7,153             | 7.3          | %   | 7,474             | 7,130             | 4.8         | %        |
| Commercial                       | 7,031  | 7,812             | (10.0)       | %   | 6,863             | 6,861             | 0.0         | %        |
| Energy                           | 3,218  | 3,690             | (12.8)       | %   | 3,984             | 4,302             | (7.4)       | %        |
| <b>Total</b>                     | <b>\$ 30,648</b>   | <b>\$ 30,804</b>  | <b>(0.5)</b> | <b>%</b>  | <b>\$ 30,143</b>  | <b>\$ 30,073</b>  | <b>0.2</b>  | <b>%</b> |

|             |            |            |     |   |            |            |      |   |
|-------------|------------|------------|-----|---|------------|------------|------|---|
| Grand Total | \$ 239,134 | \$ 220,433 | 8.5 | % | \$ 200,815 | \$ 182,025 | 10.3 | % |
|-------------|------------|------------|-----|---|------------|------------|------|---|

Casualty

Gross premiums written for the casualty segment in the third quarter of 2018 were up 9 percent, or \$12.5 million, as most products posted top line growth. Growth was led by other casualty, which includes general binding authority coverages and assumed reinsurance business with Prime. General binding authority business was launched at the beginning of 2017 and grew its top line by \$1.3 million in the third quarter of 2018 when compared to the same period in 2017. Gross premiums written for Prime have continued to grow and were up 31 percent for the quarter. Exposure growth from mature lines, newer products and rate increases led to increased premium for commercial and personal umbrella. General liability and our executive products group also made significant contributions during the quarter with both mature and newer product offerings, such as cyber liability coverages, producing exposure growth. Premiums for commercial transportation decreased 10 percent, though rates continued to increase. Medical professional liability was also down \$2.2 million in the quarter due to intensifying competition.

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## Property

Gross premiums written for the Group's property segment totaled \$50.9 million for the third quarter of 2018, up 14 percent from the same period last year. Our marine business accounted for nearly half the growth with \$19.8 million of premiums written, up 18 percent over the third quarter of 2017. Commercial property posted an increase in gross premiums written, as renewal rates for catastrophe prone wind exposures have continued to improve following hurricane activity in the third quarter of 2017. While rates have improved relative to prior quarters, the majority of the increase in gross premiums has been exposure driven. Production from specialty personal reflects increased performance from our Hawaii homeowners' product, which was up 14 percent.

## Surety

The surety segment recorded gross premiums written of \$30.6 million for the third quarter of 2018, a decrease of \$0.2 million from the same period last year. Competitive market conditions and industry consolidation of accounts led to a reduction in commercial and energy surety production, which was partially offset by an improving construction market and targeted initiatives that resulted in growth within our contract and miscellaneous lines.

## RLI Insurance Group

Underwriting income for the Group totaled \$7.8 million for the third quarter of 2018, compared to \$14.9 million of underwriting loss in the same period last year. Catastrophe losses had a larger impact in 2017, as a result of Hurricanes Harvey, Irma and Maria. Total catastrophe losses, net of related bonus and profit sharing expense offsets, was \$6.4 million in 2018, compared to \$31.7 million in 2017. Both periods reflect favorable reserve development on prior accident years, with reserve releases improving results by \$9.7 million in the third quarter of 2018 and \$14.9 million in the third quarter of 2017. The combined ratio for the Group totaled 96.1 in 2018, compared to 108.2 in 2017. The loss ratio decreased to 54.9 from 67.7, due largely to the increased level of catastrophe losses in 2017. The Group's expense ratio increased to 41.2 from 40.5.

|                                    | For the Three-Month Periods<br>Ended September 30, |             |
|------------------------------------|--|-------------|
|                                    | 2018   | 2017        |
| Underwriting income (in thousands) |  |             |
| Casualty                           | \$ (1,974)   | \$ 3,554    |
| Property                           | 2,621  | (27,519)    |
| Surety                             | 7,115  | 9,033       |
| Total                              | \$ 7,762   | \$ (14,932) |

|                |       |       |
|----------------|-------|-------|
| Combined ratio |       |       |
| Casualty       | 101.5 | 97.0  |
| Property       | 93.3  | 182.0 |
| Surety         | 76.4  | 69.9  |
| Total          | 96.1  | 108.2 |

#### Casualty

The casualty segment recorded an underwriting loss of \$2.0 million in the third quarter of 2018, compared to underwriting income of \$3.6 million for the same period last year. Underwriting results for 2018 reflect a smaller amount of favorable development on prior accident year reserves and a higher expense ratio associated with our newer casualty lines. Releases of prior accident years' reserves improved underwriting results for the casualty segment by \$6.0 million, primarily on accident years 2016 and 2017. Notable contributions toward this favorable development were from umbrella and professional services, while small commercial and medical professional liability developed adversely. In comparison, \$10.6 million of reserves were realized in the third quarter of 2017, largely driven by umbrella, general liability, professional services and medical professional liability.

The combined ratio for the casualty segment was 101.5 for 2018, compared to 97.0 in 2017. The segment's loss ratio was 65.3 in 2018, up from 62.4 in 2017. The loss ratio increased in 2018 as a result of lower favorable development on prior years' reserves. The expense ratio for the casualty segment was 36.2, up from 34.6 for the same period last year, due to new business initiatives, investments in technology and a modest shift in mix towards products with higher acquisition rates.



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### Property

The property segment recorded underwriting income of \$2.6 million for the third quarter of 2018, compared to \$27.5 million of underwriting loss for the same period last year. The loss in 2017 was the result of an active hurricane season, as total catastrophe losses reduced net underwriting income by \$29.4 million in the third quarter of 2017. Comparatively, catastrophe losses impacted the property segment's net underwriting results for 2018 by \$6.5 million as a result of Hurricane Florence. Underwriting results for 2018 included \$2.5 million of net favorable development on prior years' loss and catastrophe reserves, primarily from the marine business. Comparatively, the 2017 underwriting results include \$2.3 million of net favorable development on prior years' loss and catastrophe reserves, primarily from the marine business.

Underwriting results for the third quarter of 2018 translated into a combined ratio of 93.3, compared to 182.0 for the same period last year. The segment's loss ratio was 51.6 in 2018, down from 137.2 in 2017 due to the higher levels of catastrophe losses in the prior year. The segment's expense ratio decreased to 41.7 in 2018 from 44.8 in the prior year, due in part to the fixed nature of certain expenses and an increase in earned premium.

### Surety

The surety segment recorded underwriting income of \$7.1 million for the third quarter of 2018, compared to \$9.0 million for the same period last year. Both periods reflected positive current accident year underwriting performance and benefited from favorable development on prior years' loss reserves. Results for 2018 included favorable development on prior accident years' reserves across most surety lines, which improved net underwriting results for the segment by \$1.5 million. Comparatively, 2017 results included favorable development on prior accident years' loss reserves across all products, which improved the segment's net underwriting results by \$2.4 million.

The combined ratio for the surety segment totaled 76.4 for the third quarter of 2018, compared to 69.9 for the same period in 2017. The segment's loss ratio was 13.6 for 2018, compared to 10.8 for 2017. The loss ratio increase was the result of a lower amount of favorable development on prior accident year reserves. The expense ratio was 62.8, up from 59.1 in the prior year, due to increased investments in technology.

### Investment Income and Realized Capital Gains

Our investment portfolio generated net investment income of \$16.3 million during the third quarter of 2018, an increase of 15.0 percent from that reported for the same period in 2017. The increase in investment income was due to an increased asset base and rising interest rates compared to the prior year period. On an after-tax basis, investment

income increased by 22.1 percent, as lower tax rates also benefited income in 2018.

Yields on our fixed income investments for the third quarter of 2018 and 2017 were as follows:

|                 | 3Q 2018 |   | 3Q 2017 |   |
|-----------------|---------|---|---------|---|
| Pretax Yield    |         |   |         |   |
| Taxable         | 3.28    | % | 3.13    | % |
| Tax-Exempt      | 2.93    | % | 2.61    | % |
| After-Tax Yield |         |   |         |   |
| Taxable         | 2.59    | % | 2.03    | % |
| Tax-Exempt      | 2.78    | % | 2.47    | % |

We recognized \$18.6 million of realized gains in the third quarter of 2018, which were comprised of \$18.0 million of realized gains on equity securities from rebalancing the portfolio and \$0.8 million of realized gains on the fixed income portfolio. This compares to realized gains of \$1.1 million on the equity portfolio that were offset by \$1.0 million of other realized losses in 2017.

#### Income Taxes

Our effective tax rate for the third quarter of 2018 was 15.1 percent, compared to 301.2 percent for the same period in 2017. The Tax Cuts and Jobs Act of 2017 (TCJA) lowered the federal corporate tax rate from 35 percent to 21 percent effective January 1, 2018, which lowered the effective tax rate from the prior year. However, the larger driver of the difference was the catastrophic losses incurred in the third quarter of 2017, which resulted in a pretax loss and caused the tax favored adjustments to have a much larger impact than they did in 2018.

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## LIQUIDITY AND CAPITAL RESOURCES

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

The following table summarizes cash flows provided by (used in) our activities for the nine-month periods ended September 30, 2018 and 2017:

| (in thousands)       | 2018         | 2017         |
|----------------------|--------------|--------------|
| Operating cash flows | \$ 163,369   | \$ 145,933   |
| Investing cash flows | \$ (103,273) | \$ (114,327) |
| Financing cash flows | \$ (24,898)  | \$ (22,998)  |
| Total                | \$ 35,198    | \$ 8,608     |

Operating activities generated positive cash flows of \$163.4 million in the first nine months of 2018, compared to \$145.9 million in the same period last year. The increase in operating cash flows was due to increased premium receipts and investment income, as well as dividends received from our equity method investee, which were partially offset by a larger amount of paid loss and loss adjustment expense during the period.

We have \$149.1 million in debt outstanding. On October 2, 2013, we completed a public debt offering, issuing \$150.0 million in senior notes maturing September 15, 2023 (a 10-year maturity), and paying interest semi-annually at the rate of 4.875 percent per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$148.6 million. The estimated fair value for the senior note at September 30, 2018 was \$155.4 million. The fair value of our debt is estimated based on the limited observable prices that reflect thinly traded securities.

As of September 30, 2018, we had cash and other investments maturing within one year of approximately \$120.1 million and an additional \$378.4 million maturing between one to five years. Whereas our strategy is to be fully invested at all times, short-term investments in excess of demand deposit balances are considered a component of investment activities, and thus are classified as investments in our consolidated balance sheets.

We also maintain a revolving line of credit with JP Morgan Chase Bank N.A., which permits us to borrow up to an aggregate principal amount of \$50.0 million. This facility was entered into during the second quarter of 2018 and replaced the previous \$40.0 million facility which expired on May 28, 2018. Under certain conditions, the line may be increased up to an aggregate principal amount of \$75.0 million. The facility has a two-year term that expires on May 24, 2020. As of and during the nine-month period ended September 30, 2018, no amounts were outstanding on this facility.

Additionally, two of our insurance companies, RLI Ins. and Mt. Hawley, are members of the Federal Home Loan Bank of Chicago (FHLBC). Membership in the Federal Home Loan Bank System provides both companies access to an additional source of liquidity via a secured lending facility. Our membership allows each insurance subsidiary to determine tenor and structure at the time of borrowing. As of and during the nine-month period ended September 30, 2018, there were no outstanding borrowing amounts with the FHLBC.

We believe that cash generated by operations and investments will provide sufficient sources of liquidity to meet our anticipated needs over the next 12 to 24 months. In the event they are not sufficient, we believe cash available from financing activities and other sources will provide sufficient additional liquidity.

We have not had any liquidity issues affecting our operations as we have sufficient cash flow to support operations. In addition to our bank credit facility and FHLBC membership, our highly liquid investment portfolio provides an additional source of liquidity.

We maintain a diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of September 30, 2018, our investment portfolio had a balance sheet value of \$2.2 billion. Invested assets at September 30, 2018 have increased \$90.0 million from December 31, 2017.

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As of September 30, 2018, our investment portfolio had the following asset allocation breakdown:

Portfolio Allocation  
(in thousands)

| Asset class                     | Cost or<br>Amortized Cost | Fair<br>Value | Unrealized<br>Gain/(Loss) | % of Total<br>Fair Value | Quality* |
|---------------------------------|---------------------------|---------------|---------------------------|--------------------------|----------|
| U.S. government                 | \$ 177,339                | \$ 173,787    | \$ (3,552)                | 7.8                      | % AAA    |
| U.S. agency                     | 30,647                    | 29,903        | (744)                     | 1.3                      | % AAA    |
| Non-U.S. govt. & agency         | 8,178                     | 7,907         | (271)                     | 0.4                      | % BBB+   |
| Agency MBS                      | 415,476                   | 402,026       | (13,450)                  | 18.0                     | % AAA    |
| ABS/CMBS**                      | 120,737                   | 119,567       | (1,170)                   | 5.4                      | % AAA    |
| Corporate                       | 675,731                   | 666,692       | (9,039)                   | 29.9                     | % BBB+   |
| Municipal                       | 317,540                   | 319,735       | 2,195                     | 14.3                     | % AA     |
| Total Fixed Income              | \$ 1,745,648              | \$ 1,719,617  | \$ (26,031)               | 77.1                     | % AA-    |
| Equity                          | \$ 210,119                | \$ 394,375    | \$ 184,256                | 17.7                     | %        |
| Other Invested Assets           | \$ 38,940                 | \$ 38,777     | \$ (163)                  | 1.7                      | %        |
| Cash and Short-Term Investments | \$ 77,995                 | \$ 77,995     | \$ —                      | 3.5                      | %        |
| Total Portfolio                 | \$ 2,072,702              | \$ 2,230,764  | \$ 158,062                | 100.0                    | %        |

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

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

Our investment portfolio does not have any exposure to derivatives.

As of September 30, 2018, our fixed income portfolio had the following rating distribution:

|     |      |   |
|-----|------|---|
| AAA | 46.9 | % |
| AA  | 15.5 | % |
| A   | 20.4 | % |
| BBB | 11.1 | % |
| BB  | 3.3  | % |
| B   | 2.5  | % |
| CCC | 0.1  | % |
| NR  | 0.2  | % |

Total 100.0%

As of September 30, 2018, the duration of the fixed income portfolio was 4.7 years. Our fixed income portfolio remained well diversified, with 1,216 individual issues.

Our investment portfolio has limited exposure to structured asset-backed securities (ABS). As of September 30, 2018, we had \$93.2 million in ABS which are pools of assets collateralized by cash flows from several types of loans, including home equity, credit cards, autos and similar obligations.

As of September 30, 2018, we had \$26.3 million in commercial mortgage backed securities (CMBS) and \$402.0 million in mortgage backed securities backed by government sponsored enterprises (GSEs - Freddie Mac, Fannie Mae and Ginnie Mae). Excluding the GSE backed MBS, our exposure to ABS and CMBS was 5.4 percent of our investment portfolio at quarter end.

We had \$666.7 million in corporate fixed income securities as of September 30, 2018, which includes \$73.3 million invested in a high yield credit strategy. This portfolio consists of floating rate bank loans and bonds that are below investment grade in credit quality and offer incremental yield over our core fixed income portfolio.

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We also maintain an allocation to municipal fixed income securities. As of September 30, 2018, we had \$319.7 million in municipal securities. Approximately 85 percent of our municipal bond portfolio maintains an 'AA' or better rating, while 99 percent of the municipal bond portfolio is rated 'A' or better.

Our equity portfolio had a fair value of \$394.4 million as of September 30, 2018 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 payment of taxes.

As of September 30, 2018, our equity portfolio had a dividend yield of 2.3 percent, compared to 1.9 percent for the S&P 500 index. Because of the corporate dividend-received-deduction applicable to our dividend income, we pay an effective tax rate of 13.1 percent on dividends, compared to 21.0 percent on taxable interest and 5.3 percent on municipal bond interest income. The equity portfolio is managed in a diversified and granular manner, with 83 individual securities and three ETF positions. No single stock exposure is greater than 2 percent of the equity portfolio.

We had \$38.8 million of other invested assets at September 30, 2018, including investments in low income housing tax credit partnerships, membership in the Federal Home Loan Bank of Chicago (FHLBC) and investments in private funds. As of September 30, 2018, \$16.3 million of investments were pledged as collateral with the FHLBC to ensure timely access to the secured lending facility that ownership of FHLBC stock provides. As of and during the nine month period ending September 30, 2018, there were no outstanding borrowings with the FHLBC.

Our capital structure is comprised of equity and debt outstanding. As of September 30, 2018, our capital structure consisted of \$149.1 million in 10-year maturity senior notes maturing in 2023 (debt) and \$871.9 million of shareholders' equity. Debt outstanding comprised 14.6 percent of total capital as of September 30, 2018. Interest and fees on debt obligations totaled \$5.6 million during the nine months of 2018, the same amount as the previous year. We have incurred interest expense on debt at an average annual interest rate of 4.91 percent for the nine-month periods ended September 30, 2018 and 2017.

We paid a quarterly cash dividend of \$0.22 per share on September 20, 2018, the same as the prior quarter. We have paid dividends for 169 consecutive quarters and increased dividends in each of the last 43 years.

Our three insurance subsidiaries are subsidiaries of RLI Corp, with RLI Ins. as the first-level, or principal, insurance subsidiary. At the holding company (RLI Corp.) level, we rely largely on dividends from our insurance company subsidiaries to meet our obligations for paying principal and interest on outstanding debt, corporate expenses and dividends to RLI Corp. shareholders. As discussed further below, dividend payments to RLI Corp. from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of

the insurance regulatory authorities of Illinois. As a result, we may not be able to receive dividends from such subsidiary at times and in amounts necessary to pay desired dividends to RLI Corp. shareholders. On a GAAP basis, as of September 30, 2018, our holding company had \$871.9 million in equity. This includes amounts related to the equity of our insurance subsidiaries, which is subject to regulatory restrictions under state insurance laws. The unrestricted portion of holding company net assets is comprised primarily of investments and cash, including \$10.6 million in liquid assets, which approximates a quarter of our annual holding company expenditures. Unrestricted funds at the holding company are available to fund debt interest, general corporate obligations and dividend payments to our shareholders. If necessary, the holding company also has other potential sources of liquidity that could provide for additional funding to meet corporate obligations or pay shareholder dividends, which include a revolving line of credit, as well as access to capital markets.

Ordinary dividends, which may be paid by our principal insurance subsidiary without prior regulatory approval, are subject to certain limitations based upon statutory income, surplus and earned surplus. The maximum ordinary dividend distribution from our principal insurance subsidiary in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Ins. policyholder surplus, as of December 31 of the preceding year, or the net income of RLI Ins. for the 12-month period ending December 31 of the preceding year. Ordinary dividends are further restricted by the requirement that they be paid from earned surplus. Any dividend distribution in excess of the ordinary dividend limits is deemed extraordinary and requires prior approval from the Illinois Department of Insurance (IDOI). In the first nine months of 2018, RLI Ins. paid \$13.0 million in ordinary dividends to RLI Corp. In 2017, our principal insurance subsidiary paid ordinary dividends totaling \$107.0 million to RLI Corp. No extraordinary dividends were paid during 2018 or 2017. As of September 30, 2018, \$0.6 million of the net assets of our principal insurance subsidiary are not restricted and could be distributed to RLI Corp. as ordinary dividends. Because the limitations are based upon a rolling 12-month period, the presence, amount and impact of these restrictions vary over time. Furthermore, in addition to the unrestricted liquid net assets that RLI Corp. had on hand as of September 30, 2018,



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RLI Corp. has access to lines of credit that would cover normal annual holding company expenditures as they are incurred and become payable.

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

On an overall basis, our exposure to market risk has not significantly changed from that reported in our December 31, 2017 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 –

The information in response to this item is incorporated herein by reference to note 8 to the unaudited condensed consolidated interim financial statements, “Contingent Liabilities.”

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 2010, our Board of Directors implemented a \$100 million share repurchase program. We did not repurchase any shares during 2018. We have \$87.5 million of remaining capacity from the repurchase program. The repurchase program may be suspended or discontinued at any time without prior notice.

Item 3. Defaults Upon Senior Securities - Not Applicable.

Item 4. Mine Safety Disclosures - Not Applicable.

Item 5. Other Information - Not Applicable.

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Item 6. Exhibits

Exhibit 10.1 RLI Corp. Director and Officer Indemnification Agreement

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

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

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

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

Exhibit 101 XBRL-Related Documents

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SIGNATURES

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

RLI Corp.

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

Date: October 24, 2018