

RLI CORP  
Form 10-Q  
July 24, 2015  
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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 June 30, 2015

or

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

For the transition period from                      to

Commission File Number: 001-09463

RLI Corp.

(Exact name of registrant as specified in its charter)

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

(309) 692-1000

(Registrant's telephone number, including area code)

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

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

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

|  |                           |
|--|---------------------------|
| Large accelerated filer  | Accelerated filer         |
| Non-accelerated filer<br>(Do not check if a smaller reporting company) | Smaller reporting company |

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of July 13, 2015, the number of shares outstanding of the registrant's Common Stock was 43,232,625.

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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 June 30, |            |
|---|---|------------|
|   | 2015  | 2014       |
| Net premiums earned                             | \$ 172,339                                    | \$ 168,604 |
| Net investment income                           | 13,431  | 13,982     |
| Net realized investment gains                   | 4,802   | 10,431     |
| Consolidated revenue                            | \$ 190,572                                    | \$ 193,017 |
| Losses and settlement expenses                  | 64,549  | 73,345     |
| Policy acquisition costs                        | 59,487  | 55,156     |
| Insurance operating expenses                    | 13,467  | 13,534     |
| Interest expense on debt                        | 1,857   | 1,874      |
| General corporate expenses                      | 2,748   | 2,549      |
| Total expenses                                  | \$ 142,108                                    | \$ 146,458 |
| Equity in earnings of unconsolidated investees  | 6,186   | 5,864      |
| Earnings before income taxes                    | \$ 54,650                                     | \$ 52,423  |
| Income tax expense                              | 17,465  | 16,698     |
| Net earnings                                    | \$ 37,185                                     | \$ 35,725  |
| Other comprehensive earnings (loss), net of tax | (24,932)                                      | 19,934     |
| Comprehensive earnings                          | \$ 12,253                                     | \$ 55,659  |
| Earnings per share:                             |   |            |
| Basic:  |   |            |
| Basic net earnings per share                    | \$ 0.86                                       | \$ 0.83    |
| Basic comprehensive earnings per share          | \$ 0.28                                       | \$ 1.29    |
| Diluted:  |   |            |

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|  |         |         |
|--|---------|---------|
| Diluted net earnings per share                       | \$ 0.84 | \$ 0.82 |
| Diluted comprehensive earnings per share             | \$ 0.28 | \$ 1.27 |
| Weighted average number of common shares outstanding |         |         |
| Basic  | 43,210  | 43,001  |
| Diluted  | 44,019  | 43,688  |
| Cash dividends paid per common share                 | \$ 0.19 | \$ 0.18 |

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

| (in thousands, except per share data)                | For the Six-Month Periods<br>Ended June 30, |            |
|--|---|------------|
|  | 2015  | 2014       |
| Net premiums earned                                  | \$ 341,342                                  | \$ 329,736 |
| Net investment income                                | 26,926                                      | 27,564     |
| Net realized investment gains                        | 18,088                                      | 16,932     |
| Consolidated revenue                                 | \$ 386,356                                  | \$ 374,232 |
| Losses and settlement expenses                       | 145,410                                     | 144,361    |
| Policy acquisition costs                             | 118,460                                     | 110,207    |
| Insurance operating expenses                         | 24,998                                      | 26,067     |
| Interest expense on debt                             | 3,713                                       | 3,725      |
| General corporate expenses                           | 4,992                                       | 4,747      |
| Total expenses                                       | \$ 297,573                                  | \$ 289,107 |
| Equity in earnings of unconsolidated investees       | 10,380                                      | 9,289      |
| Earnings before income taxes                         | \$ 99,163                                   | \$ 94,414  |
| Income tax expense                                   | 31,380                                      | 29,720     |
| Net earnings   | \$ 67,783                                   | \$ 64,694  |
| Other comprehensive earnings (loss), net of tax      | (32,527)                                    | 37,671     |
| Comprehensive earnings                               | \$ 35,256                                   | \$ 102,365 |
| Earnings per share:                                  |   |            |
| Basic:   |   |            |
| Basic net earnings per share                         | \$ 1.57                                     | \$ 1.50    |
| Basic comprehensive earnings per share               | \$ 0.82                                     | \$ 2.38    |
| Diluted:   |   |            |
| Diluted net earnings per share                       | \$ 1.54                                     | \$ 1.48    |
| Diluted comprehensive earnings per share             | \$ 0.80                                     | \$ 2.34    |
| Weighted average number of common shares outstanding |   |            |
| Basic  | 43,176                                      | 42,993     |
| Diluted  | 44,008                                      | 43,669     |
| Cash dividends paid per common share                 | \$ 0.37                                     | \$ 0.35    |



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)                 | June 30,<br>2015    | December<br>31,<br>2014 |
|---|---------------------|-------------------------|
| <b>ASSETS</b>                                     |                     |                         |
| Investments                                       |                     |                         |
| Fixed income                                      |                     |                         |
| Available-for-sale, at fair value                 | \$ 1,537,365        | \$ 1,495,087            |
| Equity securities, at fair value                  | 391,152             | 410,642                 |
| Short-term investments, at cost                   | 10,169              | 16,339                  |
| Other invested assets                             | 11,069              | 11,597                  |
| Cash  | 27,087              | 30,620                  |
| Total investments and cash                        | \$ 1,976,842        | \$ 1,964,285            |
| Accrued investment income                         | 15,052              | 14,629                  |
| Premiums and reinsurance balances receivable      | 174,584             | 154,573                 |
| Ceded unearned premium                            | 52,603              | 53,961                  |
| Reinsurance balances recoverable on unpaid losses | 328,030             | 335,106                 |
| Deferred policy acquisition costs                 | 71,575              | 65,123                  |
| Property and equipment                            | 43,407              | 42,549                  |
| Investment in unconsolidated investees            | 71,179              | 60,046                  |
| Goodwill and intangibles                          | 72,249              | 72,695                  |
| Other assets                                      | 9,664               | 12,575                  |
| <b>TOTAL ASSETS</b>                               | <b>\$ 2,815,185</b> | <b>\$ 2,775,542</b>     |

**LIABILITIES AND SHAREHOLDERS' EQUITY**

|                                       |                     |                     |
|---------------------------------------|---------------------|---------------------|
| <b>Liabilities</b>                    |                     |                     |
| Unpaid losses and settlement expenses | \$ 1,142,596        | \$ 1,121,040        |
| Unearned premiums                     | 430,632             | 401,412             |
| Reinsurance balances payable          | 36,915              | 38,013              |
| Funds held                            | 54,055              | 51,481              |
| Income taxes-deferred                 | 68,462              | 82,285              |
| Bonds payable, long-term debt         | 149,647             | 149,625             |
| Accrued expenses                      | 40,303              | 63,148              |
| Other liabilities                     | 24,677              | 23,476              |
| <b>TOTAL LIABILITIES</b>              | <b>\$ 1,947,287</b> | <b>\$ 1,930,480</b> |

**Shareholders' Equity**

Common stock (\$1 par value, 100,000,000 shares authorized)  
(66,162,839 shares issued, 43,232,625 shares outstanding at 6/30/15)

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|  |              |              |
|--|--------------|--------------|
| (66,032,929 shares issued, 43,102,715 shares outstanding at 12/31/14)        | \$ 66,163    | \$ 66,033    |
| Paid-in capital  | 217,165      | 213,737      |
| Accumulated other comprehensive earnings                                     | 138,856      | 171,383      |
| Retained earnings  | 838,713      | 786,908      |
| Deferred compensation  | 14,042       | 13,769       |
| Less: Treasury shares at cost<br>(22,930,214 shares at 6/30/15 and 12/31/14) | (407,041)    | (406,768)    |
| TOTAL SHAREHOLDERS' EQUITY   | \$ 867,898   | \$ 845,062   |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY                                   | \$ 2,815,185 | \$ 2,775,542 |

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 Six-Month Periods<br>Ended June 30, |              |
|---|---|--------------|
|   | 2015  | 2014         |
| Net cash provided by operating activities         | \$ 71,121                                   | \$ 38,528    |
| Cash Flows from Investing Activities              |   |              |
| Investments purchased                             | \$ (393,382)                                | \$ (311,402) |
| Investments sold                                  | 250,602                                     | 217,403      |
| Investments called or matured                     | 81,680                                      | 49,932       |
| Net change in short-term investments              | 3,866                                       | 15,462       |
| Net property and equipment purchased              | (3,289)                                     | (4,921)      |
| Investment in equity method investee              | (1,711)                                     | (5,301)      |
| Net cash used in investing activities             | \$ (62,234)                                 | \$ (38,827)  |
| Cash Flows from Financing Activities              |   |              |
| Cash dividends paid                               | \$ (15,978)                                 | \$ (15,046)  |
| Stock plan share issuance                         | 1,779                                       | 2,760        |
| Excess tax benefit from exercise of stock options | 1,779                                       | 350          |
| Net cash used in financing activities             | \$ (12,420)                                 | \$ (11,936)  |
| Net decrease in cash                              | \$ (3,533)                                  | \$ (12,235)  |
| Cash at the beginning of the period               | \$ 30,620                                   | \$ 39,469    |
| Cash at June 30                                   | \$ 27,087                                   | \$ 27,234    |

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. BASIS OF PRESENTATION

The unaudited condensed consolidated interim financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 2014 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 June 30, 2015 and the results of operations of RLI Corp. and subsidiaries for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the operating results for a full year.

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

B. ADOPTED ACCOUNTING STANDARDS

No new accounting standards have been adopted as no issued updates would impact our financial statements.

C. PROSPECTIVE ACCOUNTING STANDARDS

ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs

This ASU was issued to simplify the presentation of debt issuance costs by requiring them to be presented in the balance sheet as a direct deduction from the carrying amount of the related recognized debt liability, consistent with debt discounts. This ASU is effective for annual and interim reporting periods beginning after December 15, 2015. Early adoption is permitted. We have not early-adopted this ASU and do not believe adoption will have a material effect on our financial statements.

ASU 2015-09, Financial Services-Insurance (Topic 944): Disclosures about Short-Duration Contracts

This ASU was issued to enhance disclosures about an entity's insurance liabilities, including the nature, amount, timing and uncertainty of cash flows related to those liabilities. The new guidance requires the disclosure of the following information related to unpaid claims and claim adjustment expenses:

- a. Net incurred and paid claims development information by accident year for the number of years for which claims incurred typically remain outstanding, but need not exceed 10 years;
- b. A reconciliation of incurred and paid claims development information to the aggregate carrying amount of the liability for unpaid claims and claim adjustment expenses, with separate disclosure of reinsurance recoverable on unpaid claims for each period presented in the statement of financial position;
- c. For each accident year presented, the total of incurred-but-not-reported liabilities plus expected development on reported claims included in the liability for unpaid claims and claim adjustment expenses;
- d. For each accident year presented, quantitative information about claim frequency accompanied by a qualitative description of methodologies used for determining claim frequency information; and
- e. For all claims, the average annual percentage payout of incurred claims by age.

This ASU is effective for annual reporting periods beginning after December 15, 2015 and for interim periods beginning after December 15, 2016. Early adoption is permitted. We have not early-adopted this ASU and while disclosures will be increased, we do not believe adoption will have a material effect on our financial statements.

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D. INTANGIBLE ASSETS

In accordance with GAAP guidelines, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill and intangible assets totaled \$72.2 million at June 30, 2015.

Goodwill and intangible assets resulting from acquisitions completed prior to 2011 totaled \$26.2 million and is attributable to our surety segment. Of this \$26.2 million, \$25.6 million relates to goodwill and \$0.6 million relates to an indefinite-lived intangible asset. Goodwill and intangible assets resulting from the Contractors Bonding and Insurance Company (CBIC) acquisition in April 2011 totaled \$30.3 million. The CBIC-related assets include goodwill attributable to our casualty and surety segments of \$5.3 million and \$15.1 million, respectively, and an indefinite-lived intangible asset in the amount of \$7.5 million, which relates to state insurance licenses. Annual impairment testing was performed on each of these goodwill and indefinite-lived intangible assets during the second quarter of 2015. Based upon these reviews, none of the assets were impaired. In addition, as of June 30, 2015, there were no triggering events that occurred that would suggest further review was necessary. Definite-lived intangible assets related to the CBIC acquisition totaled \$2.4 million, net of amortization, as of June 30, 2015.

The remaining \$15.7 million of goodwill and intangibles relates to our purchase of Rockbridge Underwriting Agency (Rockbridge) in November 2012. Of this amount, \$12.4 million is recorded as goodwill attributable to our casualty segment. The remaining \$3.3 million relates to definite-lived intangible assets, net of amortization, as of June 30, 2015. Impairment testing is performed on this goodwill asset in the fourth quarter of each year. There were no triggering events that occurred during the first half of 2015 that would suggest further review was necessary.

The aforementioned definite-lived intangible assets are amortized against future operating results based on their estimated useful lives. Amortization of intangible assets resulting from the acquisitions of CBIC and Rockbridge was \$0.2 million for the second quarter of 2015 and \$0.4 million for the six-month period ended June 30, 2015.

E. EARNINGS PER SHARE

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





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

| (in thousands, except<br>per share data)       | For the Three-Month Period<br>Ended June 30, 2015 |               |           | For the Three-Month Period<br>Ended June 30, 2014 |               |           |
|--|---|---------------|-----------|---|---------------|-----------|
|  | Income  | Shares        | Per Share | Income  | Shares        | Per Share |
|  | (Numerator)                                       | (Denominator) | Amount    | (Numerator)                                       | (Denominator) | Amount    |
| <b>Basic EPS</b>                               |   |               |           |   |               |           |
| Income available to<br>common shareholders     | \$ 37,185   | 43,210        | \$ 0.86   | \$ 35,725   | 43,001        | \$ 0.83   |
| Effect of Dilutive Securities<br>Stock options | -   | 809           |           | -   | 687           |           |
| <b>Diluted EPS</b>                             |   |               |           |   |               |           |
| Income available to<br>common shareholders     | \$ 37,185   | 44,019        | \$ 0.84   | \$ 35,725   | 43,688        | \$ 0.82   |
| (in thousands, except<br>per share data)       | For the Six-Month Period<br>Ended June 30, 2015   |               |           | For the Six-Month Period<br>Ended June 30, 2014   |               |           |
|  | Income  | Shares        | Per Share | Income  | Shares        | Per Share |
|  | (Numerator)                                       | (Denominator) | Amount    | (Numerator)                                       | (Denominator) | Amount    |
| <b>Basic EPS</b>                               |   |               |           |   |               |           |
| Income available to<br>common shareholders     | \$ 67,783   | 43,176        | \$ 1.57   | \$ 64,694   | 42,993        | \$ 1.50   |
| Effect of Dilutive Securities<br>Stock options | -   | 832           |           | -   | 676           |           |
| <b>Diluted EPS</b>                             |   |               |           |   |               |           |
| Income available to<br>common shareholders     | \$ 67,783   | 44,008        | \$ 1.54   | \$ 64,694   | 43,669        | \$ 1.48   |

**F. COMPREHENSIVE EARNINGS**

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

Unrealized losses for the first six months of 2015 were \$32.5 million compared to unrealized gains of \$37.7 million during the same period last year. Fixed income securities declined in market value during 2015 as interest rates rose and our conservative positioning in the equity portfolio underperformed the market over the same period. In 2014, both fixed income and equity securities experienced positive price movements.

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

| (in thousands)   | For the Three-Month Periods<br>Ended June 30, |            | For the Six-Month Periods<br>Ended June 30, |            |
|--|---|------------|---|------------|
|  | 2015  | 2014       | 2015  | 2014       |
| Unrealized Gains/Losses on Available-for-Sale Securities           |   |            |   |            |
| Beginning balance  | \$ 163,788                                    | \$ 153,764 | \$ 171,383                                  | \$ 136,027 |
| Other comprehensive earnings before reclassifications              | (21,760)                                      | 26,714     | (20,764)                                    | 48,674     |
| Amounts reclassified from accumulated other comprehensive earnings | (3,172)                                       | (6,780)    | (11,763)                                    | (11,003)   |
| Net current-period other comprehensive earnings (loss)             | \$ (24,932)                                   | \$ 19,934  | \$ (32,527)                                 | \$ 37,671  |
| Ending balance   | \$ 138,856                                    | \$ 173,698 | \$ 138,856                                  | \$ 173,698 |

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

| (in thousands)   | Amount Reclassified from Accumulated Other Comprehensive Earnings |           |  |           | Affected line item in the Statement of Earnings              |
|--|---|-----------|--|-----------|--|
|  | For the Three-Month Periods Ended June 30,                        |           | For the Six-Month Periods Ended June 30, |           |  |
| Component of Accumulated Other Comprehensive Earnings        | 2015  | 2014      | 2015                                     | 2014      |  |
| Unrealized gains and losses on available-for-sale securities | \$ 4,880  | \$ 10,431 | \$ 18,097                                | \$ 16,928 | Net realized investment gains                                |
|  | -   | -         | -  | -         | Other-than-temporary impairment (OTTI) losses on investments |
|  | \$ 4,880  | \$ 10,431 | \$ 18,097                                | \$ 16,928 | Earnings before income taxes                                 |
|  | (1,708)   | (3,651)   | (6,334)                                  | (5,925)   | Income tax expense   |
|  | \$ 3,172  | \$ 6,780  | \$ 11,763                                | \$ 11,003 | Net earnings   |

## 2. INVESTMENTS

Our investments include fixed income debt securities and common stock equity securities. As disclosed in our 2014 Annual Report on Form 10-K, we present all of our investments as available-for-sale, which are carried at fair value. During the fourth quarter of 2014, we sold our last remaining fixed income security that was classified as held-to-maturity. When available, we obtain quoted market prices to determine fair value for our investments. If a quoted market price is not available, fair value is estimated using a secondary pricing source or using quoted market prices of similar securities. We have no investment securities for which fair value is determined using Level 3 inputs as defined in note 3 to the unaudited condensed consolidated interim financial statements, "Fair Value Measurements."

### Available-for-Sale Securities

The amortized cost and fair value of available-for-sale securities at June 30, 2015 and December 31, 2014 were as follows:

Available-for-sale  
(in thousands)

| Asset Class             | 6/30/2015                    |                              |                               |               |
|-------------------------|------------------------------|------------------------------|-------------------------------|---------------|
|                         | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. government         | \$ 30,281                    | \$ 129                       | \$ (10)                       | \$ 30,400     |
| U.S. agency             | 13,499                       | 229                          | (84)                          | 13,644        |
| Non-U.S. govt. & agency | 1,893                        | -                            | (53)                          | 1,840         |
| Agency MBS              | 232,883                      | 7,680                        | (1,383)                       | 239,180       |
| ABS/CMBS*               | 87,214                       | 1,429                        | (344)                         | 88,299        |
| Corporate               | 595,886                      | 14,694                       | (8,620)                       | 601,960       |
| Municipal               | 553,346                      | 11,746                       | (3,050)                       | 562,042       |
| Total Fixed Income      | \$ 1,515,002                 | \$ 35,907                    | \$ (13,544)                   | \$ 1,537,365  |
| Equity                  | \$ 198,607                   | \$ 193,648                   | \$ (1,103)                    | \$ 391,152    |

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

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(in thousands)

| Asset Class             | 12/31/2014                   |                              |                               |               |
|-------------------------|------------------------------|------------------------------|-------------------------------|---------------|
|                         | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. government         | \$ 33,668                    | \$ 131                       | \$ (11)                       | \$ 33,788     |
| U.S. agency             | 6,385                        | 362                          | -                             | 6,747         |
| Non-U.S. govt. & agency | 9,862                        | 803                          | -                             | 10,665        |
| Agency MBS              | 256,443                      | 9,401                        | (1,376)                       | 264,468       |
| ABS/CMBS*               | 133,894                      | 1,821                        | (411)                         | 135,304       |
| Corporate               | 543,183                      | 23,697                       | (4,190)                       | 562,690       |
| Municipal               | 464,769                      | 16,789                       | (133)                         | 481,425       |
| Total Fixed Income      | \$ 1,448,204                 | \$ 53,004                    | \$ (6,121)                    | \$ 1,495,087  |
| Equity                  | \$ 193,535                   | \$ 218,105                   | \$ (998)                      | \$ 410,642    |

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\*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 June 30, 2015:

| Available-for-sale<br>(in thousands)  | 6/30/2015         |               |
|---------------------------------------|-------------------|---------------|
|                                       | Amortized<br>Cost | Fair<br>Value |
| Due in one year or less               | \$ 9,309          | \$ 9,391      |
| Due after one year through five years | 259,490           | 265,403       |
| Due after five years through 10 years | 599,500           | 608,967       |
| Due after 10 years                    | 326,606           | 326,125       |
| Mtge/ABS/CMBS*                        | 320,097           | 327,479       |
| Total available-for-sale              | \$ 1,515,002      | \$ 1,537,365  |

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

## Unrealized Losses

We conduct and document periodic reviews of all securities with unrealized losses to evaluate whether the impairment is other-than-temporary. The following tables are used as part of our impairment analysis and illustrate the total value

of securities that were in an unrealized loss position as of June 30, 2015 and December 31, 2014. The tables segregate the securities based on type, noting the fair value, cost (or amortized cost) and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position. As of June 30, 2015 unrealized losses, as shown in the following tables, were 0.7 percent of total invested assets. Unrealized losses increased in 2015, as interest rates increased during the first half of the year.

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| (in thousands)                | June 30, 2015 |                      |             | December 31, 2014 |                      |            |
|-------------------------------|---------------|----------------------|-------------|-------------------|----------------------|------------|
|                               | < 12 Mos.     | 12 Mos. &<br>Greater | Total       | < 12 Mos.         | 12 Mos. &<br>Greater | Total      |
| <b>U.S. Government</b>        |               |                      |             |                   |                      |            |
| Fair value                    | \$ 5,307      | \$ —                 | \$ 5,307    | \$ 4,416          | \$ —                 | \$ 4,416   |
| Cost or amortized cost        | 5,317         | —                    | 5,317       | 4,427             | —                    | 4,427      |
| Unrealized Loss               | \$ (10)       | \$ —                 | \$ (10)     | \$ (11)           | \$ —                 | \$ (11)    |
| <b>U.S. Agency</b>            |               |                      |             |                   |                      |            |
| Fair value                    | \$ 7,026      | \$ —                 | \$ 7,026    | \$ —              | \$ —                 | \$ —       |
| Cost or amortized cost        | 7,110         | —                    | 7,110       | —                 | —                    | —          |
| Unrealized Loss               | \$ (84)       | \$ —                 | \$ (84)     | \$ —              | \$ —                 | \$ —       |
| <b>Non-U.S. government</b>    |               |                      |             |                   |                      |            |
| Fair value                    | \$ 1,840      | \$ —                 | \$ 1,840    | \$ —              | \$ —                 | \$ —       |
| Cost or amortized cost        | 1,893         | —                    | 1,893       | —                 | —                    | —          |
| Unrealized Loss               | \$ (53)       | \$ —                 | \$ (53)     | \$ —              | \$ —                 | \$ —       |
| <b>Agency MBS</b>             |               |                      |             |                   |                      |            |
| Fair value                    | \$ 60,153     | \$ 20,107            | \$ 80,260   | \$ 12,840         | \$ 61,534            | \$ 74,374  |
| Cost or amortized cost        | 60,974        | 20,669               | 81,643      | 12,947            | 62,803               | 75,750     |
| Unrealized Loss               | \$ (821)      | \$ (562)             | \$ (1,383)  | \$ (107)          | \$ (1,269)           | \$ (1,376) |
| <b>ABS/CMBS*</b>              |               |                      |             |                   |                      |            |
| Fair value                    | \$ 31,524     | \$ 4,157             | \$ 35,681   | \$ 63,782         | \$ 11,616            | \$ 75,398  |
| Cost or amortized cost        | 31,845        | 4,180                | 36,025      | 64,084            | 11,725               | 75,809     |
| Unrealized Loss               | \$ (321)      | \$ (23)              | \$ (344)    | \$ (302)          | \$ (109)             | \$ (411)   |
| <b>Corporate</b>              |               |                      |             |                   |                      |            |
| Fair value                    | \$ 230,965    | \$ 9,825             | \$ 240,790  | \$ 123,617        | \$ 14,488            | \$ 138,105 |
| Cost or amortized cost        | 239,010       | 10,400               | 249,410     | 127,634           | 14,661               | 142,295    |
| Unrealized Loss               | \$ (8,045)    | \$ (575)             | \$ (8,620)  | \$ (4,017)        | \$ (173)             | \$ (4,190) |
| <b>Municipal</b>              |               |                      |             |                   |                      |            |
| Fair value                    | \$ 173,994    | \$ —                 | \$ 173,994  | \$ 12,382         | \$ 19,019            | \$ 31,401  |
| Cost or amortized cost        | 177,044       | —                    | 177,044     | 12,411            | 19,123               | 31,534     |
| Unrealized Loss               | \$ (3,050)    | \$ —                 | \$ (3,050)  | \$ (29)           | \$ (104)             | \$ (133)   |
| <b>Subtotal, fixed income</b> |               |                      |             |                   |                      |            |
| Fair value                    | \$ 510,809    | \$ 34,089            | \$ 544,898  | \$ 217,037        | \$ 106,657           | \$ 323,694 |
| Cost or amortized cost        | 523,193       | 35,249               | 558,442     | 221,503           | 108,312              | 329,815    |
| Unrealized Loss               | \$ (12,384)   | \$ (1,160)           | \$ (13,544) | \$ (4,466)        | \$ (1,655)           | \$ (6,121) |
| <b>Equity securities</b>      |               |                      |             |                   |                      |            |
| Fair value                    | \$ 14,227     | \$ —                 | \$ 14,227   | \$ 10,837         | \$ —                 | \$ 10,837  |

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|                        |             |            |             |            |            |            |
|------------------------|-------------|------------|-------------|------------|------------|------------|
| Cost or amortized cost | 15,330      | —          | 15,330      | 11,835     | —          | 11,835     |
| Unrealized Loss        | \$ (1,103)  | \$ —       | \$ (1,103)  | \$ (998)   | \$ —       | \$ (998)   |
| Total                  |             |            |             |            |            |            |
| Fair value             | \$ 525,036  | \$ 34,089  | \$ 559,125  | \$ 227,874 | \$ 106,657 | \$ 334,531 |
| Cost or amortized cost | 538,523     | 35,249     | 573,772     | 233,338    | 108,312    | 341,650    |
| Unrealized Loss        | \$ (13,487) | \$ (1,160) | \$ (14,647) | \$ (5,464) | \$ (1,655) | \$ (7,119) |

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



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The following table shows the composition of the fixed income securities in unrealized loss positions at June 30, 2015 by the National Association of Insurance Commissioners (NAIC) rating and the generally equivalent Standard & Poor's (S&P) and Moody's ratings. The vast majority of the securities are rated by S&P and/or Moody's.

| NAIC Rating | Equivalent S&P Rating | Equivalent Moody's Rating | (dollars in thousands) |            | Unrealized Loss | Percent to Total |   |
|-------------|-----------------------|---------------------------|------------------------|------------|-----------------|------------------|---|
|             |                       |                           | Amortized Cost         | Fair Value |                 |                  |   |
| 1           | AAA/AA/A              | Aaa/Aa/A                  | \$ 422,894             | \$ 414,108 | \$ (8,786)      | 64.9             | % |
| 2           | BBB                   | Baa                       | 90,037                 | 86,789     | (3,248)         | 24.0             | % |
| 3           | BB                    | Ba                        | 26,131                 | 25,368     | (763)           | 5.6              | % |
| 4           | B                     | B                         | 19,243                 | 18,512     | (731)           | 5.4              | % |
| 5           | CCC or lower          | Caa or lower              | 137                    | 121        | (16)            | 0.1              | % |
| 6           |                       |                           | —                      | —          | —               | —                |   |
|             |                       | Total                     | \$ 558,442             | \$ 544,898 | \$ (13,544)     | 100.0            | % |

## Evaluating Investments for OTTI

The fixed income portfolio contained 355 securities in an unrealized loss position as of June 30, 2015. The \$13.5 million in associated unrealized losses for these 355 securities represents 0.9 percent of the fixed income portfolio's cost basis. Of these 355 securities, 33 have been in an unrealized loss position for 12 consecutive months or longer. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. Any credit-related impairment related to fixed income securities we do not plan to sell and for which we are not more likely than not to be required to sell is recognized in net earnings, with the non-credit related impairment recognized in comprehensive earnings. Based on our analysis, our fixed income portfolio is of high credit quality and we believe we will recover the amortized cost basis of our fixed income securities. We continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. There were no other-than-temporary impairment (OTTI) losses recognized in net earnings or other comprehensive earnings in the periods presented on the fixed income portfolio.

As of June 30, 2015, we held five common stock securities that were in an unrealized loss position. The unrealized loss on these securities was \$1.1 million. Based on our analysis, we believe each security will recover in a reasonable period of time and we have the intent and ability to hold them until recovery. No equity securities have been in an unrealized loss position for 12 consecutive months or longer. There were no OTTI losses recognized in the periods presented on the equity portfolio.

## Other Invested Assets

Other invested assets include an investment in a low income housing tax credit partnership, carried at amortized cost, and membership in the Federal Home Loan Bank Chicago (FHLBC), carried at cost. Our interest in a low income housing tax credit partnership had a balance of \$9.5 million at June 30, 2015 compared to \$9.8 million at December 31, 2014 and recognized a total tax benefit of \$0.2 million during the second quarter of 2015 and \$0.5 million during the six-month period ended June 30, 2015. Our investment in FHLBC stock totaled \$1.6 million at June 30, 2015 compared to \$1.8 million at December 31, 2014.

## Cash and Short-term Investments

Cash consists of uninvested balances in bank accounts. We had a cash balance of \$27.1 million at the end of the second quarter of 2015, compared to \$30.6 million at the end of 2014. Short-term investments are carried at cost, which approximates fair value. The balance at June 30, 2015 was \$10.2 million compared to \$16.3 million at December 31, 2014.

### 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.

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

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

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

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

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

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

Corporate, Agencies, Government and Municipal Bonds: The pricing vendor employs a multi-dimensional model which uses standard inputs including (listed in 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: Exchange traded equities have readily observable price levels and are classified as Level 1 (fair value based on quoted market prices). All of our common stock holdings are deemed Level 1.

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

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

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

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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 June 30, 2015   |  |   | Total        |
|-------------------------------------|---|--|---|--------------|
|                                     | Fair Value Measurements Using                                   |  |   |              |
|                                     | Quoted Prices<br>Active Market<br>Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Other<br>Significant<br>Unobservable<br>Inputs<br>(Level 3) |              |
| Available-for-sale securities       |   |  |   |              |
| U.S. government                     | \$ —  | \$ 30,400  | \$ —  | \$ 30,400    |
| U.S. agency                         | —   | 13,644   | —   | 13,644       |
| Non-U.S. govt. & agency             | —   | 1,840  | —   | 1,840        |
| Agency MBS                          | —   | 239,180  | —   | 239,180      |
| ABS/CMBS*                           | —   | 88,299   | —   | 88,299       |
| Corporate                           | —   | 601,960  | —   | 601,960      |
| Municipal                           | —   | 562,042  | —   | 562,042      |
| Equity                              | 391,152   | —  | —   | 391,152      |
| Total available-for-sale securities | \$ 391,152  | \$ 1,537,365                                     | \$ —  | \$ 1,928,517 |

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

| (in thousands)                      | As of December 31, 2014   |  |   | Total        |
|-------------------------------------|---|--|---|--------------|
|                                     | Fair Value Measurements Using                                   |  |   |              |
|                                     | Quoted Prices<br>Active Market<br>Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Other<br>Significant<br>Unobservable<br>Inputs<br>(Level 3) |              |
| Available-for-sale securities       |   |  |   |              |
| U.S. government                     | \$ —  | \$ 33,788  | \$ —  | \$ 33,788    |
| U.S. agency                         | —   | 6,747  | —   | 6,747        |
| Non-U.S. govt. & agency             | —   | 10,665   | —   | 10,665       |
| Agency MBS                          | —   | 264,468  | —   | 264,468      |
| ABS/CMBS*                           | —   | 135,304  | —   | 135,304      |
| Corporate                           | —   | 562,690  | —   | 562,690      |
| Municipal                           | —   | 481,425  | —   | 481,425      |
| Equity                              | 410,642   | —  | —   | 410,642      |
| Total available-for-sale securities | \$ 410,642  | \$ 1,495,087                                     | \$ —  | \$ 1,905,729 |

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

As noted in the above table, we did not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period. Additionally, there were no securities transferred in or out of levels 1 or 2 during the six-month period ended June 30, 2015.

#### 4. INCOME TAXES

Our effective tax rate for the three and six-month periods ended June 30, 2015 was 32 percent compared to 31 percent for the same periods in 2014. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate was higher for the three and six-month periods ended June 30, 2015 due to an increase in underwriting income compared to the same periods in 2014.

Income tax expense attributable to income from operations for the three and six-month periods ended June 30, 2015 and 2014 differed from the amounts computed by applying the U.S. federal tax rate of 35 percent to pretax income as a result of the following:

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| (in thousands)  | For the Three-Month Periods Ended June 30, |     |           |     | For the Six-Month Periods Ended June 30, |     |           |     |
|---|--|-----|-----------|-----|--|-----|-----------|-----|
|   | 2015                                       |     | 2014      |     | 2015                                     |     | 2014      |     |
|   | Amount                                     | %   | Amount    | %   | Amount                                   | %   | Amount    | %   |
| Provision for income taxes at the statutory rate of 35% | \$ 19,127                                  | 35  | \$ 18,348 | 35  | \$ 34,707                                | 35  | \$ 33,045 | 35  |
| Increase (reduction) in taxes resulting from:           |  |     |           |     |  |     |           |     |
| Tax exempt interest income                              | (1,054)                                    | (2) | (1,048)   | (2) | (2,016)                                  | (2) | (2,082)   | (2) |
| Dividends received deduction                            | (535)                                      | (1) | (533)     | (1) | (1,112)                                  | (1) | (1,131)   | (1) |
| ESOP dividends paid deduction                           | (238)                                      | —   | (220)     | (1) | (458)                                    | —   | (421)     | (1) |
| Other items, net  | 165  | —   | 151       | —   | 259                                      | —   | 309       | —   |
| Total tax expense                                       | \$ 17,465                                  | 32  | \$ 16,698 | 31  | \$ 31,380                                | 32  | \$ 29,720 | 31  |

## 5. 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, including 53,500 in the first quarter of 2015. The 2010 LTIP was replaced in the second quarter of 2015.

During the second quarter of 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, 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 or 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). Thus far in 2015, we have granted 412,000 stock options under the 2015 LTIP.

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 the vesting period, the requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.



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The following tables summarize option activity for the periods ended June 30, 2015 and 2014:

|  | 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, 2015 | 2,892,717                           | \$ 26.65                                 |   |   |
| Options granted                        | 465,500                             | \$ 49.52                                 |   |   |
| Options exercised                      | (215,617)                           | \$ 18.97                                 |   | \$ 6,620                                      |
| Options canceled/forfeited             | (4,560)                             | \$ 31.87                                 |   |   |
| Outstanding options at June 30, 2015   | 3,138,040                           | \$ 30.56                                 | 5.28  | \$ 65,356                                     |
| Exercisable options at June 30, 2015   | 1,441,660                           | \$ 22.48                                 | 4.02  | \$ 41,674                                     |

|  | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in 000's) |
|--|-------------------------------------|--|---|---|
| Outstanding options at January 1, 2014 | 2,595,084                           | \$ 26.04                                 |   |   |
| Options granted                        | 420,000                             | \$ 42.88                                 |   |   |
| Options exercised                      | (43,872)                            | \$ 18.31                                 |   | \$ 1,139                                      |
| Options canceled/forfeited             | (740)                               | \$ 16.51                                 |   |   |
| Outstanding options at June 30, 2014   | 2,970,472                           | \$ 28.53                                 | 5.47  | \$ 51,232                                     |
| Exercisable options at June 30, 2014   | 1,300,292                           | \$ 22.02                                 | 4.21  | \$ 30,894                                     |

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 2015, 465,500 stock options were granted with a weighted average exercise price of \$49.52 and a weighted average fair value of \$8.94. We recognized \$1.1 million of expense in the second quarter of 2015 and \$2.0 million in the first six months of 2015 related to options vesting. Since options granted under 2010 LTIP and 2015 LTIP are non-qualified, we recorded a tax benefit of \$0.4 million in the second quarter of 2015 and \$0.7 million in the first six months of 2015 related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$6.8 million, which will be recognized over the remainder of the vesting period. Comparatively, we recognized \$1.2 million of expense in the second quarter of 2014 and \$2.1 million of expense in the first six months of 2014. We recorded a tax benefit of \$0.4 million in the second quarter of 2014 and \$0.7 million in the first six months of 2014 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 June 30:

|                                       | 2015       | 2014       |
|---------------------------------------|------------|------------|
| Weighted-average fair value of grants | \$ 8.94    | \$ 7.76    |
| Risk-free interest rates              | 1.54 %     | 1.70 %     |
| Dividend yield                        | 1.81 %     | 1.94 %     |
| Expected volatility                   | 22.89%     | 23.22%     |
| Expected option life                  | 5.21 years | 5.18 years |

The risk-free rate was determined based on U.S. treasury yields that most closely approximated the option's expected life. The dividend yield was calculated based on the average annualized ordinary dividends paid during the most recent five-year period. It excluded the special dividends paid in the fourth quarters of 2014 and prior years. The expected volatility was calculated based 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.

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During the first quarter of 2014, each outside director received \$10,000 worth of restricted common shares from the 2010 LTIP as part of director compensation. The shares were directly owned by each director on the date of issuance and included a one-year restriction on the sale or transfer of such shares. In the first quarter of 2014, we issued a total of 2,097 restricted shares and recognized \$0.1 million of compensation expense. This restricted share program was terminated in 2014.

## 6. 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.

| REVENUES<br>(in thousands)                     | For the Three-Month Periods<br>Ended June 30, |            | For the Six-Month Periods<br>Ended June 30, |            |
|--|---|------------|---|------------|
|  | 2015  | 2014       | 2015  | 2014       |
| Net premiums earned:                           |   |            |   |            |
| Casualty                                       | \$ 101,914                                    | \$ 94,360  | \$ 200,682                                  | \$ 185,337 |
| Property                                       | 41,281  | 48,791     | 83,399                                      | 92,109     |
| Surety   | 29,144  | 25,453     | 57,261                                      | 52,290     |
| Segment totals before income taxes             | \$ 172,339                                    | \$ 168,604 | \$ 341,342                                  | \$ 329,736 |
| Net investment income                          | 13,431  | 13,982     | 26,926                                      | 27,564     |
| Net realized gains                             | 4,802   | 10,431     | 18,088                                      | 16,932     |
| Total consolidated revenue                     | \$ 190,572                                    | \$ 193,017 | \$ 386,356                                  | \$ 374,232 |
| NET EARNINGS<br>(in thousands)                 | 2015  | 2014       | 2015  | 2014       |
| Casualty                                       | \$ 19,201                                     | \$ 16,467  | \$ 24,473                                   | \$ 22,545  |
| Property                                       | 4,828   | 2,293      | 13,004                                      | 11,971     |
| Surety   | 10,807  | 7,809      | 14,997                                      | 14,585     |
| Net underwriting income                        | \$ 34,836                                     | \$ 26,569  | \$ 52,474                                   | \$ 49,101  |
| Net investment income                          | 13,431  | 13,982     | 26,926                                      | 27,564     |
| Net realized gains                             | 4,802   | 10,431     | 18,088                                      | 16,932     |
| General corporate expense and interest on debt | (4,605)                                       | (4,423)    | (8,705)                                     | (8,472)    |
| Equity in earnings of unconsolidated investees | 6,186   | 5,864      | 10,380                                      | 9,289      |
| Total earnings before income taxes             | \$ 54,650                                     | \$ 52,423  | \$ 99,163                                   | \$ 94,414  |
| Income tax expense                             | 17,465  | 16,698     | 31,380                                      | 29,720     |

|                    |           |           |           |           |
|--------------------|-----------|-----------|-----------|-----------|
| Total net earnings | \$ 37,185 | \$ 35,725 | \$ 67,783 | \$ 64,694 |
|--------------------|-----------|-----------|-----------|-----------|

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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 June 30, |                   | For the Six-Month Periods<br>Ended June 30, |                   |
|---------------------------------------|---|-------------------|---|-------------------|
|                                       | 2015  | 2014              | 2015  | 2014              |
| <b>Casualty</b>                       |   |                   |   |                   |
| Commercial and personal umbrella      | \$ 26,012                                     | \$ 25,024         | \$ 51,309                                   | \$ 49,780         |
| General liability                     | 20,607  | 20,523            | 40,579                                      | 40,455            |
| Professional services                 | 17,641  | 13,839            | 34,721                                      | 26,700            |
| Commercial transportation             | 15,117  | 15,005            | 29,798                                      | 29,516            |
| P&C package business                  | 9,909   | 8,495             | 19,558                                      | 16,778            |
| Executive products                    | 4,601   | 4,721             | 9,286                                       | 9,405             |
| Medical professional liability        | 3,032   | 3,724             | 6,136                                       | 7,424             |
| Other casualty                        | 4,995   | 3,029             | 9,295                                       | 5,279             |
| Total                                 | \$ 101,914                                    | \$ 94,360         | \$ 200,682                                  | \$ 185,337        |
| <b>Property</b>                       |   |                   |   |                   |
| Commercial property                   | \$ 19,049                                     | \$ 20,054         | \$ 38,952                                   | \$ 40,487         |
| Marine                                | 10,984  | 12,962            | 22,901                                      | 25,163            |
| Specialty personal                    | 6,657   | 6,709             | 13,447                                      | 12,817            |
| Property reinsurance                  | 3,342   | 3,387             | 6,359                                       | 6,748             |
| Crop reinsurance                      | 1,222   | 5,683             | 1,687                                       | 6,869             |
| Other property                        | 27  | (4)               | 53  | 25                |
| Total                                 | \$ 41,281                                     | \$ 48,791         | \$ 83,399                                   | \$ 92,109         |
| <b>Surety</b>                         |   |                   |   |                   |
| Miscellaneous                         | \$ 10,489                                     | \$ 9,598          | \$ 20,657                                   | \$ 19,080         |
| Commercial                            | 7,592   | 6,313             | 14,493                                      | 12,447            |
| Contract                              | 6,789   | 6,256             | 13,619                                      | 13,017            |
| Oil and Gas                           | 4,274   | 3,286             | 8,492                                       | 7,746             |
| Total                                 | \$ 29,144                                     | \$ 25,453         | \$ 57,261                                   | \$ 52,290         |
| <b>Grand Total</b>                    | <b>\$ 172,339</b>                             | <b>\$ 168,604</b> | <b>\$ 341,342</b>                           | <b>\$ 329,736</b> |

## 7. ACQUISITION

On February 5, 2014, we invested \$5.3 million for a 20 percent equity ownership interest in Prime Holdings Insurance Services, Inc. (Prime), an Illinois domiciled insurance carrier based in Salt Lake City, Utah. On March 4, 2015 we invested an additional \$1.7 million, increasing our total equity ownership to 27 percent. Prime's primary subsidiary, Prime Insurance Company, is a privately-held excess and surplus lines insurance company operating in 49 states and territories through a network of wholesale brokers and specializing in hard-to-place risks. The investment in Prime is

reflected on our balance sheet as an investment in unconsolidated investee. Under the equity method of accounting we recognize our proportionate share of Prime's income as equity in earnings of unconsolidated investees. Our share of Prime's earnings amounted to \$0.3 million in the second quarter of 2015 and \$0.8 million in the first six months of 2015. Comparatively, our share of Prime's earnings amounted to \$0.2 million in the second quarter of 2014 and \$0.3 million in the first six months of 2014.

Additionally, we entered into a 25 percent quota share reinsurance treaty with Prime's two insurance subsidiaries, effective January 1, 2014. We assumed gross premiums of \$3.6 million in the second quarter of 2015 and \$6.7 million in the first six months of 2015 related to this quota share agreement. Comparatively, we assumed gross premiums of \$2.5 million in the second quarter of 2014 and \$5.0 million in the first six months of 2014 related to this quota share agreement.

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

“SAFE HARBOR” STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: This discussion and analysis may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Various risk factors that could affect future results are listed in our filings with the Securities and Exchange Commission, including the Annual Report on Form 10-K for the year ended December 31, 2014.

OVERVIEW

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

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

effectively. Often, the development of these coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients or loss exposures. Once a proposal is submitted, our underwriters determine whether it would be a viable product based on our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all market conditions and we achieved this for 19 consecutive years, averaging an 87.4 combined ratio over that period of time. This foundation drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly-rated, diversified, liquid investment-grade securities. Consistent underwriting income allows a portion of our shareholders' equity to be invested in equity securities. Our equity portfolio consists of a core stock portfolio weighted toward dividend-paying stocks, as well as exchange traded funds (ETFs). Our minority equity ownership interests in Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality sunglasses, and Prime Holdings Insurance Services, Inc. (Prime), a specialty excess and surplus insurance company, has also enhanced overall returns. We have a diversified investment portfolio and closely monitor our investment risks. Despite periodic fluctuations in market value, our equity portfolio is part of a long-term asset allocation strategy and has contributed significantly to our historic growth in book value.

We measure the results of our insurance operations by monitoring certain measures of growth and profitability across three distinct business segments: casualty, property and surety. Growth is measured in terms of gross premiums written and



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profitability is analyzed through combined ratios, which are further subdivided into their respective loss and expense components.

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

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

The casualty portion of our business consists largely of general liability, personal umbrella, transportation, executive products and commercial umbrella coverages, as well as package business and other specialty coverages, such as professional liability and workers compensation for office-based professionals. We offer fidelity and crime coverage for commercial insureds and select financial institutions and recently expanded our casualty offerings to include medical and healthcare professional liability coverage in the excess and surplus market. We also assume select casualty business for excess and surplus accounts through our quota share reinsurance agreement with Prime. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty segment is also subject to inflation risk and may be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

Our property segment is comprised primarily of commercial fire, earthquake, difference in conditions, marine and facultative and treaty reinsurance including crop. We also offer select personal lines policies, such as recreational vehicle and Hawaii homeowners coverages. While our marine and facultative reinsurance coverages are predominantly domestic risks, these portfolios do contain a relatively small portion of foreign risks. Property insurance and reinsurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our second largest catastrophe exposure is to losses caused by 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. Our assumed multi-peril crop and hail treaty reinsurance business covers revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects and disease. Significant aggregation of these losses is mitigated by the U.S. Federal Government reinsurance program that provides stop loss protection inuring to our benefit. As noted in previous filings, our portion of assumed crop reinsurance was reduced for 2015 and will

expire at the end of the current crop year due to the acquisition of the cedant.

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

The insurance marketplace remains intensely competitive. New entrants, alternative capital and a lack of significant catastrophe activity led to flat or declining prices for many coverages in 2014, and continues to impact our business. Despite these challenges, 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.

On May 27, 2015, RLI Ins. and Mt. Hawley entered into a stock purchase agreement to sell RIC to Clear Blue Financial Holdings, LLC, for \$7.5 million to be paid in cash at closing. RIC is being sold as a "shell" with the primary value being derived from the transfer of insurance licenses. RIC has minimal assets and written premium and is currently transferring all

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premium and loss cash flows to RLI Ins. through a 100 percent reinsurance agreement. After closing, RLI Ins. will reinsure all then-existing RIC bond and insurance liabilities, adjust claims and service the remaining in-force policies and bonds until they terminate or are moved into RLI Ins. The transaction is structured as a sale of the stock of RIC by Mt. Hawley and is subject to Form A approval, a revision to the existing reinsurance agreement and a dividend, all of which are subject to insurance department regulatory approval. We would expect to close promptly after such approvals are secured.

## GAAP and non-GAAP Financial Performance Metrics

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

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

### Underwriting Income

Underwriting income or profit represents one measure of the pretax profitability of our insurance operations and is derived by subtracting losses and settlement expenses, policy acquisition costs and insurance operating expenses from net premiums earned. Each of these captions is presented in the statements of earnings, but not subtotaled. However, this information is available in total and by segment in note 11 to the consolidated financial statements in our 2014 Annual Report on Form 10-K, regarding operating segment information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains/losses on investments, general corporate expenses, debt costs and earnings from unconsolidated investees.

### Combined Ratio

This ratio is a common industry measure of profitability for any underwriting operation and is calculated in two components. First, the loss ratio is losses and settlement expenses divided by net premiums earned. The second component, the expense ratio, reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. All items included in these components of the combined ratio are presented in our GAAP financial statements. The sum of the loss and expense ratios is the combined ratio. The difference between the

combined ratio and 100 reflects the per-dollar rate of underwriting income or loss. For example, a combined ratio of 85 implies that for every \$100 of premium we earn, we record \$15 of underwriting income.

#### Net Unpaid Loss and Settlement Expenses

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

#### Critical Accounting Policies

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

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation and OTTI, recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes. For a detailed discussion of each of these policies, refer to our 2014 Annual Report on Form 10-K. There have been no significant changes to any of these policies during the current year.

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## SIX MONTHS ENDED JUNE 30, 2015 COMPARED TO SIX MONTHS ENDED JUNE 30, 2014

Consolidated revenues, as displayed in the table that follows, totaled \$386.4 million for the first six months of 2015 compared to \$374.2 million for the same period in 2014.

|                                      | For the Six-Month<br>Periods<br>Ended June 30, |            |
|--------------------------------------|--|------------|
|                                      | 2015   | 2014       |
| Consolidated revenues (in thousands) |  |            |
| Net premiums earned                  | \$ 341,342                                     | \$ 329,736 |
| Net investment income                | 26,926   | 27,564     |
| Net realized investment gains        | 18,088   | 16,932     |
| Total consolidated revenue           | \$ 386,356                                     | \$ 374,232 |

Consolidated revenue for the first six months of 2015 increased \$12.1 million, or 3 percent, from the same period in 2014. Net premiums earned for the Group increased 4 percent, driven by growth from our casualty and surety segments, which were up 8 percent and 10 percent, respectively. Due to the current low yield environment, net investment income decreased 2 percent to \$26.9 million. Net realized investment gains totaled \$18.1 million in the first six months of 2015, compared to \$16.9 million in 2014.

Net after-tax earnings for the first six months of 2015 totaled \$67.8 million, \$1.54 per diluted share, compared to \$64.7 million, \$1.48 per diluted share, for the same period last year. Results for both periods reflected positive underwriting results for the current accident year and also benefited from favorable development on prior years' loss reserves. From a prior accident year standpoint, favorable development resulted in additional pretax earnings of \$43.5 million in the first six months of 2015 compared to \$42.3 million in 2014. Results for 2014 also include \$1.3 million of reinsurance reinstatement premium related to unfavorable development on prior years' surety reserves. Underwriting results for both periods were impacted by losses from storm activity, which totaled \$7.4 million in the first half of 2015, compared to \$8.0 million for the same period last year. Bonus and profit sharing-related expenses related to prior year reserve development and storm losses totaled \$5.3 million in 2015, compared to \$4.5 million in 2014. 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 six months of 2015, equity in earnings of unconsolidated investees totaled \$10.4 million. This amount includes \$9.6 million from Maui Jim and \$0.8 million from Prime. Comparatively, the first six months of 2014 reflected \$9.3 million of earnings, including \$9.0 million from Maui Jim and \$0.3 million from Prime. Refer to Note 6, Acquisitions, for more information regarding our recent investments in Prime.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$35.3 million, \$0.80 per diluted share, for the first six months of 2015, compared to \$102.4 million, \$2.34 per diluted share, for the first half of 2014. Unrealized losses, net of tax, in the first six months of 2015 were \$32.5 million, compared to unrealized gains of \$37.7 million for the same period in 2014. Unrealized losses in the current year were split evenly between the equity and fixed income portfolios.

## RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group decreased 5 percent to \$438.7 million for the first six months of 2015. The overall decline was driven by our property segment, down 29 percent, due largely to reduced premium from our assumed crop business. Excluding the impact of crop, gross premiums written increased 4 percent from prior year, as our casualty and surety segments each delivered solid growth. From a pricing standpoint, trends have varied across our product portfolio. While certain products such as transportation, recreational vehicles and umbrella have achieved price increases during the year, excess and surplus property coverages continue to face a difficult rate environment. Most notably, double digit price declines for catastrophe exposed coverages have persisted through the first half of 2015. Net premiums written were up slightly in the first six months of 2015, as cost savings realized during our 2015 reinsurance renewals served to offset the decline seen on a gross basis. During the first half of 2015 we renewed all material reinsurance treaties, which resulted in an \$8.5 million reduction in ceded premiums from improved reinsurance rates, while some coverages were expanded. Excluding the impact of crop, net premiums written increased 6 percent. On a net premiums earned basis, premiums increased \$11.6 million, or 4 percent, due to overall growth experienced in recent periods. Much of this growth is attributable to our casualty and surety segments, where net premiums earned were up 8 percent and 10 percent, respectively. Underwriting income for the

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Group totaled \$52.5 million for the first six months of 2015, compared to \$49.1 million in 2014. Results for both periods reflect similar amounts of favorable development in prior years' loss and catastrophe reserves. Net storm losses in the current year were \$0.5 million less than in 2014. Both periods also delivered positive underwriting results from a current accident year standpoint. The GAAP combined ratio totaled 84.6 in 2015, compared to 85.1 in 2014. The loss ratio decreased to 42.6 from 43.8, while the Group's expense ratio increased slightly to 42.0 from 41.3.

|                                       | For the Six-Month<br>Periods<br>Ended June 30, |            |
|---------------------------------------|--|------------|
|                                       | 2015   | 2014       |
| Gross premiums written (in thousands) |  |            |
| Casualty                              | \$ 264,792                                     | \$ 244,238 |
| Property                              | 112,938  | 159,888    |
| Surety                                | 60,936   | 57,442     |
| Total                                 | \$ 438,666                                     | \$ 461,568 |
| Underwriting income (in thousands)    |  |            |
| Casualty                              | \$ 24,473                                      | \$ 22,545  |
| Property                              | 13,004   | 11,971     |
| Surety                                | 14,997   | 14,585     |
| Total                                 | \$ 52,474                                      | \$ 49,101  |
| Combined ratio                        |  |            |
| Casualty                              | 87.8   | 87.8       |
| Property                              | 84.4   | 87.0       |
| Surety                                | 73.8   | 72.1       |
| Total                                 | 84.6   | 85.1       |

## Casualty

Gross premiums written for the casualty segment increased 8 percent, to \$264.8 million for the first six months of 2015, compared to \$244.2 million for the first six months of 2014. Growth in the segment was led by transportation, which increased \$7.9 million (19 percent) to \$48.4 million, due largely to increased opportunities to write new business. Improved pricing for transportation coverages during the first half of the year also benefited top line production. Our professional services group and P&C package business also made significant contributions to overall growth, up 16 percent and 17 percent, respectively, as expansion efforts for these products continued. Assumed premium from our quota share reinsurance treaty with Prime's two insurance subsidiaries improved as well, up \$1.7 million (34 percent) in the first half of 2015. Growth from these products offset a moderate decline from our executive products book, which decreased \$1.1 million (5 percent), due to competitive pressures in this market.

The casualty segment recorded underwriting income of \$24.5 million in the first six months of 2015, compared to \$22.5 million for the same period last year. Underwriting results for both periods benefited from favorable development on prior years' loss and catastrophe reserves. During the first half of 2015, we released reserves which improved the segment's underwriting results by \$28.7 million. Products with favorable development included general liability, umbrella, transportation, P&C package, professional services group and medical professional liability, while executive products experienced unfavorable development. From an accident year standpoint, the majority of the favorable development occurred on more recent accident years (2007-2014). Losses from 2015 storms were minimal, impacting results by \$0.1 million. Comparatively, 2014 results included favorable development on prior accident years' loss reserves, primarily for general liability, umbrella, P&C package, transportation, professional services and executive products, which improved the segment's underwriting results by \$29.3 million. Results for 2014 were also impacted by storm losses, primarily related to our P&C package business, which reduced underwriting income for the segment by \$1.9 million.

Segment results for 2015 translated into a combined ratio of 87.8, the same as in 2014. The segment's loss ratio was 52.3 in 2015, improved slightly from 52.6 in the prior year. From an expense standpoint, results were also consistent across both periods, as the segments' expense ratio was 35.5 in 2015 compared to 35.2 in 2014.



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Property

Gross premiums written for the Group's property segment totaled \$112.9 million for the first six months of 2015, a decrease of \$47.0 million, or 29 percent, from the same period last year. The majority of this decline relates to our crop reinsurance business, which declined \$39.2 million (83 percent). As noted in previous filings, we expect reduced premiums as our crop reinsurance share was reduced for 2015 and will expire at the end of the current crop year due to the acquisition of the cedant.

This segment continues to be pressured by increased competition and alternative capital, which has led to decreased rates for excess and surplus property coverages. The declining rate environment impacted premiums from our commercial property business, as our fire and difference in conditions products declined 9 percent and 12 percent, respectively. Our recreational vehicles program also posted decreased premium in the first half of 2015, down 16 percent from the prior year. The decline in this book was due to re-underwriting efforts initiated in the latter part of 2014 in response to heightened loss activity. While premiums were down for the year, double digit rate increases on retained business have been achieved as a result of these efforts. Partially offsetting these declines was a modest increase in our other property reinsurance program, which was up 2 percent, while premiums from marine and Hawaii homeowners were flat versus the prior year.

Underwriting income for the segment was \$13.0 million for the first six months of 2015, compared to \$12.0 million for the same period last year. Results for both periods reflect positive underwriting income for the current accident year and favorable development on prior years' loss and catastrophe reserves. Underwriting results for 2015 include favorable development on prior years' loss and catastrophe reserves, primarily on marine business, which improved the segment's underwriting results by \$3.7 million. This favorable development partially offset losses recorded on 2015 storms, which reduced the segment's underwriting results by \$6.2 million. From a comparative standpoint, underwriting results for 2014 included favorable development of \$0.7 million and \$4.9 million in storm losses.

Segment results for the first six months of 2015 translated into a combined ratio of 84.4 compared to 87.0 for the same period last year. The segment's loss ratio decreased to 41.3 in 2015 from 47.4 in 2014 due to the increased benefit from favorable development on prior years' reserves in 2015. From an expense standpoint, the segment's expense ratio for the first six months of 2015 increased to 43.1, from 39.6 in the prior year. The increased expense ratio relates to shifts in product mix within the segment, in particular with regard to crop, which carried a very low acquisition expense rate.

Surety

The surety segment recorded gross premiums written of \$60.9 million for the first six months of 2015, an increase of \$3.5 million, or 6 percent, from the same period last year. Premium growth was achieved despite highly competitive

conditions in this space, as new entrants and increased capacity continue to impact the market. Growth was led by miscellaneous surety, which increased \$2.2 million (11 percent) for the year, while commercial surety also delivered solid results, up \$1.4 million (10 percent). Gross premiums written from oil and gas surety and contract surety were relatively flat.

The surety segment recorded underwriting income of \$15.0 million, compared to \$14.6 million for the same period last year. Both periods benefited from favorable development on prior years' loss reserves and positive underwriting performance from a current accident year standpoint. Results for 2015 included favorable development on prior accident years' loss reserves which improved the segment's underwriting results by \$5.5 million. Each product within the segment experienced favorable development. From a comparative standpoint, 2014 results included favorable development on prior accident years' loss reserves which improved the segment's underwriting results by \$7.0 million. This favorable development was partially offset by reinsurance reinstatement premium related to unfavorable development on prior years' surety reserves which reduced underwriting income by \$1.1 million.

The combined ratio for the surety segment totaled 73.8 for the first six months of 2015, compared to 72.1 for the same period in 2014. The segment's loss ratio was 10.5 for 2015, compared to 6.1 for 2014. The loss ratio increase was due largely to the lower benefit from favorable development on prior years' reserves in 2015. The expense ratio improved to 63.3 in 2015, from 66.0 in 2014, due to shifts in mix during 2015 towards products with lower acquisition expense rates. In addition, the above-mentioned reinstatement premium contributed to a higher expense ratio in the prior year.

#### INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net investment income of \$26.9 million during the first six months of 2015, a decrease of 2.3 percent from that reported for the same period in 2014. The decrease in investment income was due to a lower yield environment during the first six months of 2015. On an after-tax basis, investment income decreased by 2.5 percent.

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| (in thousands)                  | 6/30/2015            |        | 12/31/2014           |        |
|---------------------------------|----------------------|--------|----------------------|--------|
|                                 | Financial Stmt Value | %      | Financial Stmt Value | %      |
| Fixed income                    | \$ 1,537,365         | 77.8 % | \$ 1,495,087         | 76.1 % |
| Equity securities               | 391,152              | 19.8 % | 410,642              | 20.9 % |
| Other invested assets           | 11,069               | 0.5 %  | 11,597               | 0.6 %  |
| Cash and short-term investments | 37,256               | 1.9 %  | 46,959               | 2.4 %  |
| Total                           | \$ 1,976,842         | 100.0% | \$ 1,964,285         | 100.0% |

Our current equity allocation represents 20 percent of our total investment portfolio.

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

Yields on our fixed income investments for the first six months of 2015 and 2014 were as follows:

|                 | 2015   | 2014   |
|-----------------|--------|--------|
| Pretax Yield    |        |        |
| Taxable         | 3.41 % | 3.67 % |
| Tax-Exempt      | 2.79 % | 2.76 % |
| After-Tax Yield |        |        |
| Taxable         | 2.22 % | 2.39 % |
| Tax-Exempt      | 2.64 % | 2.61 % |

The fixed income portfolio increased by \$42.3 million in the first six months of 2015. The increase is due to allocating the majority of cash flows to the fixed income portfolio. This portfolio had a tax-adjusted total return on a mark-to-market basis of 0.7 percent. Average fixed income duration was 5.0 years at June 30, 2015, reflecting our current liability structure and sound capital position.

The equity portfolio decreased by \$19.5 million during the first six months of 2015, to \$391.2 million, and had a total return of -2.5 percent through June 30, 2015.

We recognized \$18.1 million in realized gains in the first six months of 2015, compared to realized gains of \$16.9 million in the same period of 2014. Realized gains were evenly distributed between the equity and fixed income portfolios. We did not record any realized losses associated with OTTI of securities during the first six months of 2015.

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The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of June 30, 2015, including fair value, cost basis and unrealized gains and losses.

| (in thousands)         | 6/30/2015<br>Cost<br>Basis | Fair Value | Unrealized<br>Gains | Losses     | Net        | Unrealized<br>Gain/Loss % (1) |   |
|------------------------|----------------------------|------------|---------------------|------------|------------|-------------------------------|---|
| Consumer discretionary | \$ 11,984                  | \$ 28,552  | \$ 16,568           | \$ —       | \$ 16,568  | 138.3                         | % |
| Consumer staples       | 14,886                     | 33,297     | 18,663              | (252)      | 18,411     | 123.7                         | % |
| Energy                 | 10,939                     | 26,023     | 15,306              | (222)      | 15,084     | 137.9                         | % |
| Financials             | 31,704                     | 53,981     | 22,277              | —          | 22,277     | 70.3                          | % |
| Healthcare             | 4,859                      | 23,598     | 18,739              | —          | 18,739     | 385.7                         | % |
| Industrials            | 17,512                     | 35,145     | 17,633              | —          | 17,633     | 100.7                         | % |
| Information technology | 15,729                     | 28,844     | 13,115              | —          | 13,115     | 83.4                          | % |
| Materials              | 2,220                      | 6,885      | 4,665               | —          | 4,665      | 210.1                         | % |
| Telecommunications     | 4,393                      | 11,809     | 7,416               | —          | 7,416      | 168.8                         | % |
| Utilities              | 35,849                     | 55,434     | 20,214              | (629)      | 19,585     | 54.6                          | % |
| ETF                    | 48,532                     | 87,584     | 39,052              | —          | 39,052     | 80.5                          | % |
|                        | \$ 198,607                 | \$ 391,152 | \$ 193,648          | \$ (1,103) | \$ 192,545 | 96.9                          | % |

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

## INCOME TAXES

Our effective tax rate for the first six months of 2015 was 32 percent compared to 31 percent for the same period in 2014. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the first six months of 2015 was higher due to an increase in underwriting income compared to 2014.

## THREE MONTHS ENDED JUNE 30, 2015 COMPARED TO THREE MONTHS ENDED JUNE 30, 2014

Consolidated revenues, as displayed in the table that follows, totaled \$190.6 million for the second quarter of 2015 compared to \$193.0 million for the same period in 2014.

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|                                      | For the Three-Month Periods<br>Ended June 30, |            |
|--------------------------------------|---|------------|
|                                      | 2015  | 2014       |
| Consolidated revenues (in thousands) |   |            |
| Net premiums earned                  | \$ 172,339                                    | \$ 168,604 |
| Net investment income                | 13,431  | 13,982     |
| Net realized investment gains        | 4,802   | 10,431     |
| Total consolidated revenue           | \$ 190,572                                    | \$ 193,017 |

Consolidated revenue for the second quarter of 2015 decreased \$2.4 million, or 1 percent, from the same period in 2014. Net premiums earned for the Group increased 2 percent for the quarter, driven by growth from our casualty and surety segments, which were up 8 percent and 15 percent, respectively. Due to the current yield environment, net investment income decreased 4 percent to \$13.4 million. Net realized investment gains totaled \$4.8 million in the second quarter of 2015, compared to \$10.4 million in 2014.

Net after-tax earnings for the second quarter of 2015 totaled \$37.2 million, \$0.84 per diluted share, compared to \$35.7 million, \$0.82 per diluted share, for the same period last year. Results for both periods reflect positive underwriting results for the current accident year and also benefited from favorable development on prior years' loss and catastrophe reserves. In the second quarter of 2015, favorable development on prior years' loss and catastrophe reserves resulted in additional pretax earnings of \$35.5 million. Partially offsetting this favorable development was \$7.4 million in storm losses. Comparatively, in the second quarter of 2014 favorable development on prior years' loss and catastrophe reserves resulted in additional pretax earnings of \$27.5 million, partially offset by \$8.0 million in losses from storms. Results for 2014 were also impacted by \$1.3 million of reinsurance reinstatement premium related to unfavorable development on prior years' surety reserves. Bonus and profit sharing-related expenses related to prior year reserve development and storm losses totaled \$4.2 million in 2015, compared to \$2.7 million in 2014.

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During the second quarter of 2015, equity in earnings of unconsolidated investees totaled \$6.2 million. This amount includes \$5.9 million from Maui Jim and \$0.3 million from Prime. Comparatively, the second quarter of 2014 reflected \$5.9 million of earnings, including \$5.7 million from Maui Jim and \$0.2 million from Prime. Refer to Note 6, Acquisitions, for more information regarding our recent investments in Prime.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$12.3 million, \$0.28 per diluted share, for the second quarter of 2015, compared to \$55.7 million, \$1.27 per diluted share, for the second quarter of 2014. Unrealized losses, net of tax, for the second quarter of 2015 were \$24.9 million, compared to unrealized gains of \$19.9 million for the same period in 2014. Unrealized losses in the second quarter of 2015 were primarily due to a decline in the fixed income portfolio.

## RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group decreased 6 percent to \$248.1 million for the second quarter of 2015. The overall decline was driven by our property segment, down 36 percent, due largely to reduced premium from our assumed crop business. Declines within the property segment extended beyond crop, however, as ongoing competition in the excess and surplus market continued to pressure premium production. Excluding the impact of crop, gross premiums written increased 7 percent from prior year, as our casualty and surety segments each improved, up 14 percent and 7 percent, respectively. From a pricing standpoint, trends have varied across our product portfolio, with certain products such as transportation, recreational vehicles and umbrella achieving rate increases. Pricing for catastrophe exposed coverages, however, continued to experience double digit declines during the quarter, consistent with recent trends for these lines. Net premiums written increased 1 percent in the quarter, outpacing results on a gross written basis due largely to cost savings realized during our 2015 reinsurance renewals. Excluding the impact of crop, net premiums written increased 9 percent. On a net premiums earned basis, premiums increased \$3.7 million, or 2 percent, due to overall growth experienced in recent periods. Much of this growth is attributable to our casualty and surety segments, where net premiums earned were up 8 percent and 15 percent, respectively, from the prior year. Underwriting income for the Group totaled \$34.8 million for the second quarter of 2015, compared to \$26.6 million in 2014. Both periods reflect positive underwriting results for the current accident year and favorable reserve development on prior accident years. Favorable development on prior years' loss and catastrophe reserves improved underwriting results by \$30.1 million in 2015, compared to \$22.3 million in the prior year. Storm losses impacted results for both periods as well, reducing underwriting earnings by \$6.3 million and \$6.8 million, respectively. The GAAP combined ratio totaled 79.8 in 2015, compared to 84.2 in 2014. The loss ratio decreased to 37.5 from 43.5, while the Group's expense ratio increased to 42.3 from 40.7 due to changes in product mix.

For the Three-Month Periods  
 Ended June 30,  
 2015                      2014

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|                                       |            |            |
|---------------------------------------|------------|------------|
| Gross premiums written (in thousands) |            |            |
| Casualty                              | \$ 150,885 | \$ 132,283 |
| Property                              | 64,842     | 101,735    |
| Surety                                | 32,372     | 30,152     |
| Total                                 | \$ 248,099 | \$ 264,170 |
| Underwriting income (in thousands)    |            |            |
| Casualty                              | \$ 19,201  | \$ 16,467  |
| Property                              | 4,828      | 2,293      |
| Surety                                | 10,807     | 7,809      |
| Total                                 | \$ 34,836  | \$ 26,569  |
| Combined ratio                        |            |            |
| Casualty                              | 81.1       | 82.5       |
| Property                              | 88.3       | 95.3       |
| Surety                                | 62.9       | 69.3       |
| Total                                 | 79.8       | 84.2       |



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## Casualty

Gross premiums written for the casualty segment increased 14 percent to \$150.9 million for the second quarter of 2015, compared to \$132.3 million for the second quarter of 2014. Growth was experienced from most products within the segment, as expansion efforts, newer product initiatives and improved pricing on certain coverages all contributed to the improved top line. Our transportation product delivered excellent results in the quarter, posting gross premiums written of \$34.0 million, up \$8.0 million (31 percent). The growth in transportation resulted from increased opportunities to write new business and moderately improved pricing for these coverages. Our professional services group also contributed significantly to growth, as expansion efforts have driven a \$3.3 million (18 percent) increase in gross premiums written. This business provides coverages to architects, engineers and other professional classes, and continues to post premium growth as we expand these offerings nationwide. Among other products which delivered solid results in the quarter was our P&C package business, which increased gross premiums written by 17 percent, as well as umbrella, up \$4.2 million (13 percent), and general liability, up \$1.9 million (9 percent). Assumed premium from our quota share reinsurance treaty with Prime's two insurance subsidiaries also improved, up \$1.2 million (48 percent) in the quarter. Growth from these products more than offset moderate declines from our executive products business, which decreased 10 percent, and our medical professional liability book, where prices have declined.

The casualty segment recorded underwriting income of \$19.2 million in the second quarter of 2015, compared to \$16.5 million for the same period last year. Underwriting results for both periods benefited from favorable development on prior years' loss and catastrophe reserves. During the second quarter of 2015, we released reserves which improved the segment's underwriting results by \$21.1 million. Products with favorable development included general liability, umbrella, transportation, P&C package, medical professional liability and executive products. From an accident year standpoint, the majority of the favorable development occurred on more recent accident years (2008-2014). Losses from 2015 storms were minimal, impacting results by \$0.1 million. Comparatively, 2014 results included favorable development on prior accident years' loss reserves, primarily for general liability, umbrella, P&C package, transportation and professional services, which improved the segment's underwriting results by \$20.3 million. Results for 2014 were also impacted by storm losses, primarily related to our P&C package business, which reduced underwriting income for the segment by \$1.9 million.

Overall, the combined ratio for the casualty segment was 81.1 for 2015 compared to 82.5 in 2014. The segment's loss ratio was 45.4 in 2015 compared to 47.5 in 2014. The loss ratio decrease was due largely to the higher level of favorable development on prior years' reserves and the lower amount of storm losses in 2015. The expense ratio for the casualty segment was 35.7 for the second quarter of 2015 compared to 35.0 for the same period in 2014.

## Property

Gross premiums written for the Group's property segment totaled \$64.8 million for the second quarter of 2015, a decrease of \$36.9 million, or 36 percent, from the same period last year. The majority of this decline relates to our crop reinsurance business, which declined \$31.3 million (84 percent) in the quarter. As noted in previous filings, we

expect reduced premiums as our crop reinsurance share was reduced for 2015 and will expire at the end of the current crop year due to the acquisition of the cedant.

In addition to the impact from crop, premium production in this segment continues to be pressured by increased competition and alternative capital, which have caused prices for excess and surplus property coverages to decline. As a result, premiums from our commercial property business declined in the quarter, with our fire and difference in conditions products down \$2.7 million (11 percent) and \$2.0 million (15 percent), respectively. Our recreational vehicles program also posted decreased premium in the second quarter, down 14 percent from the same period last year. The decline in this book was due to re-underwriting efforts initiated in the latter part of 2014 in response to heightened loss activity. While premiums were down for the year, double digit rate increases on retained business have been achieved as a result of these efforts. Premiums from marine declined slightly as well, following consecutive quarters of top line growth for this business. The re-underwriting of our marine business was completed in the second half of 2014. Partially offsetting these decreases, gross written premiums from our other property reinsurance program increased 11 percent and Hawaii homeowners improved 2 percent.

Underwriting income for the segment was \$4.8 million for the second quarter of 2015, compared to \$2.3 million for the same period last year. Results for both periods reflect positive underwriting income for the current accident year. Underwriting results for 2015 include favorable development on prior years' loss and catastrophe reserves, primarily on marine business, which improved the segment's underwriting results by \$3.9 million. This favorable development partially offset losses recorded on 2015 storms, which reduced the segment's underwriting results by \$6.2 million. From a comparative standpoint, underwriting results for 2014 included unfavorable development on prior years' loss and catastrophe reserves which impacted underwriting results by \$1.4 million and \$4.9 million in storm losses.

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Segment results for the second quarter of 2015 translated into a combined ratio of 88.3 compared to 95.3 for the same period last year. The segment's loss ratio decreased to 44.6 in 2015 from 57.9 in 2014 due to increased favorable development on prior years' loss and catastrophe reserves in 2015. From an expense standpoint, the segment's expense ratio for the second quarter was 43.7 for 2015, compared to 37.4 in 2014. The increased expense ratio relates primarily to shifts in product mix, in particular with regard to crop, which carried a very low acquisition expense rate.

Surety

The surety segment recorded gross premiums written of \$32.4 million for the second quarter of 2015, an increase of \$2.2 million, or 7 percent, from the same period last year. Premium growth was achieved despite highly competitive conditions in this space, as new entrants and increased capacity continue to impact the market. Growth was led by commercial surety, which increased \$1.2 million (17 percent) in the quarter, while miscellaneous surety also delivered solid results, up \$1.2 million (11 percent). Gross premiums written from oil and gas surety and contract surety were relatively flat.

The surety segment recorded underwriting income of \$10.8 million, compared to \$7.8 million for the same period last year. Results for 2015 included favorable development on prior accident years' loss reserves which improved the segment's underwriting results by \$5.8 million. From a comparative standpoint, 2014 results included favorable development on prior accident years' loss reserves which improved the segment's underwriting results by \$4.9 million. Also impacting 2014 results were reinsurance reinstatement premiums related to unfavorable development in prior years' surety reserves which reduced underwriting income by \$1.1 million. Underwriting performance for both periods reflects positive current accident year results.

The combined ratio for the surety segment totaled 62.9 for the second quarter of 2015, compared to 69.3 for the same period in 2014. The segment's loss ratio was -0.7 for 2015, compared to 0.8 for 2014. The loss ratio decrease was due largely to the higher benefit from favorable development on prior years' reserves in 2015. The expense ratio improved to 63.6 for the second quarter of 2015, from 68.5 in the second quarter of 2014, due to shifts in mix towards products with lower acquisition expense rates. In addition, the above-mentioned reinstatement premium contributed to a higher expense ratio in the prior year.

INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net investment income of \$13.4 million during the second quarter of 2015, a decrease of 3.9 percent from that reported for the same period in 2014. The decrease in investment income was due to the current yield environment. On an after-tax basis, investment income decreased by 3.4 percent.

Our current equity allocation represents 20 percent of our total investment portfolio.

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

Yields on our fixed income investments for the second quarter of 2015 and 2014 were as follows:

|                 | 2Q 2015 |   | 2Q 2014 |   |
|-----------------|---------|---|---------|---|
| Pretax Yield    |         |   |         |   |
| Taxable         | 3.39    | % | 3.67    | % |
| Tax-Exempt      | 2.69    | % | 2.79    | % |
| After-Tax Yield |         |   |         |   |
| Taxable         | 2.20    | % | 2.39    | % |
| Tax-Exempt      | 2.55    | % | 2.64    | % |

We recognized \$4.8 million in realized gains in the second quarter of 2015, compared to realized gains of \$10.4 million in the same period of 2014. Realized gains were evenly distributed between the equity and fixed income portfolios. We did not record any realized losses associated with OTTI of securities during the second quarter of 2015.

## INCOME TAXES

Our effective tax rate for the second quarter of 2015 was 32 percent compared to 31 percent for the same period in 2014. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for the second quarter of 2015 was higher due to an increase in underwriting income compared to 2014.

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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 six-month periods ended June 30, 2015 and 2014:

|                      | 2015           | 2014        |
|----------------------|----------------|-------------|
|                      | (in thousands) |             |
| Operating cash flows | \$ 71,121      | \$ 38,528   |
| Investing cash flows | \$ (62,234)    | \$ (38,827) |
| Financing cash flows | \$ (12,420)    | \$ (11,936) |
| Total                | \$ (3,533)     | \$ (12,235) |

Operating activities generated positive cash flows of \$71.1 million in the first six months of 2015 compared to \$38.5 million in the same period last year. The increase in operating cash flows was due largely to reduced levels of paid losses relative to the prior year.

We have \$149.6 million in debt outstanding. On October 2, 2013, we completed a public debt offering, issuing \$150.0 million in senior notes maturing September 15, 2023 (a 10-year maturity), and paying interest semi-annually at the rate of 4.875 percent per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$148.6 million. The estimated fair value for the senior note at June 30, 2015 was \$154.5 million. The fair value of our debt is estimated based on the limited observable prices that reflect thinly traded securities.

As of June 30, 2015, we had cash, short-term investments and other investments maturing within one year of approximately \$46.6 million and an additional \$287.4 million maturing between one to five years. As of June 30, 2015, our short-term investments were held primarily in government/agency funds. All funds are NAIC-rated, AAA-rated and maintain average weighted maturities of less than 60 days. Holdings within each of these funds comply with regulatory limitations.

Whereas our strategy is to be fully invested at all times, short-term investments in excess of demand deposit balances are considered a component of investment activities, and thus are classified as investments in our consolidated balance sheets.

We also maintain a revolving line of credit with JP Morgan Chase Bank N.A., which permits us to borrow up to an aggregate principal amount of \$40.0 million. This facility was entered into during the second quarter of 2014 and replaced the previous \$25.0 million facility which expired on May 31, 2014. Under certain conditions, the line may be increased up to an aggregate principal amount of \$65.0 million. The facility has a four-year term that expires on May 28, 2018. As of and during the six-month period ended June 30, 2015, no amounts were outstanding on this facility.

Additionally, during the third quarter of 2014, two of our insurance companies, RLI Ins. and Mt. Hawley, became members of the Federal Home Loan Bank of Chicago (FHLBC). Membership in the Federal Home Loan Bank System will provide both companies access to an additional source of liquidity via a secured lending facility. Our membership allows each insurance subsidiary to determine tenor and structure at the time of borrowing. As of and during the six-month period ended June 30, 2014, there were no outstanding borrowing amounts with FHLBC.

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

We have not had any liquidity issues affecting our operations as we have sufficient cash flow to support operations. In addition to our bank credit facility 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 June 30, 2015, our investment portfolio had a balance sheet value of \$2.0 billion. Invested assets at June 30, 2015, have increased \$12.6 million from December 31, 2014.

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As of June 30, 2015, our investment portfolio had the following asset allocation breakdown:

Portfolio Allocation  
(in thousands)

| Asset class                     | Cost or<br>Amortized Cost | Fair<br>Value | Unrealized<br>Gain/(Loss) | % of Total<br>Fair Value | Quality* |
|---------------------------------|---------------------------|---------------|---------------------------|--------------------------|----------|
| U.S. agency                     | \$ 13,499                 | \$ 13,644     | \$ 145                    | 0.7                      | % AA+    |
| Corporate                       | 595,886                   | 601,960       | 6,074                     | 30.5                     | % BBB+   |
| Agency MBS                      | 232,883                   | 239,180       | 6,297                     | 12.1                     | % AA+    |
| ABS/CMBS**                      | 87,214                    | 88,299        | 1,085                     | 4.5                      | % AAA    |
| Non-U.S. govt. & agency         | 1,893                     | 1,840         | (53)                      | 0.1                      | % BBB+   |
| U.S. government                 | 30,281                    | 30,400        | 119                       | 1.5                      | % AAA    |
| Municipal                       | 553,346                   | 562,042       | 8,696                     | 28.4                     | % AA     |
| Total Fixed Income              | \$ 1,515,002              | \$ 1,537,365  | \$ 22,363                 | 77.8                     | % AA-    |
| Equity                          | \$ 198,607                | \$ 391,152    | \$ 192,545                | 19.8                     | %        |
| Other Invested Assets           | \$ 11,069                 | \$ 11,069     | \$ —                      | 0.5                      | %        |
| Cash and Short-Term Investments | \$ 37,256                 | \$ 37,256     | \$ —                      | 1.9                      | %        |
| Total Portfolio                 | \$ 1,761,934              | \$ 1,976,842  | \$ 214,908                | 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 June 30, 2015, our fixed income portfolio had the following rating distribution:

|     |      |   |
|-----|------|---|
| AAA | 16.3 | % |
| AA  | 44.3 | % |
| A   | 21.8 | % |
| BBB | 10.9 | % |
| BB  | 3.6  | % |
| B   | 2.8  | % |

|       |       |   |
|-------|-------|---|
| CCC   | 0.0   | % |
| NR    | 0.3   | % |
| Total | 100.0 | % |

As of June 30, 2015, the duration of the fixed income portfolio was 5.0 years. Our fixed income portfolio remained well diversified, with 1,039 individual issues as of June 30, 2015.

Our investment portfolio has limited exposure to structured asset-backed securities (ABS). As of June 30, 2015, we had \$36.8 million in ABS which are pools of assets collateralized by cash flows from several types of loans, including home equity, credit cards, autos and similar obligations. The majority of our asset-backed portfolio is comprised of rate reduction utility bonds.

As of June 30, 2015, we had \$51.5 million in commercial mortgage backed securities (CMBS) and \$239.2 million in residential mortgage backed securities backed by government sponsored enterprises (GSEs - Freddie Mac, Fannie Mae and Ginnie Mae). Excluding the GSE backed MBS, our exposure to ABS and CMBS was 4.5 percent of our investment portfolio at quarter end.

We had \$602.0 million in corporate fixed income securities as of June 30, 2015. As of June 30, 2015, we had \$70.8 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 June 30, 2015, we had \$562.0 million in municipal securities. As of June 30, 2015, approximately 91 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.

At June 30, 2015, our equity portfolio had a fair value of \$391.2 million and is also a source of liquidity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. In the equity portfolio, the strategy remains one of value investing, with security selection taking precedence over market timing. We use a buy-and-hold strategy, minimizing both transactional costs and taxes.

As of June 30, 2015, our equity portfolio had a dividend yield of 2.9 percent compared to 2.1 percent for the S&P 500 index. Because of the corporate dividend-received-deduction applicable to our dividend income, we pay an effective tax rate of 14.2 percent on dividends, compared to 35.0 percent on taxable interest and 5.3 percent on municipal bond interest income. The equity portfolio is managed in a diversified and granular manner, with 82 individual names and no single stock exposure greater than 2 percent of the equity portfolio.

Other invested assets include an investment in a low income housing tax credit partnership as well as membership in the Federal Home Loan Bank Chicago. Our interest in a low income housing tax credit partnership had a balance of \$9.5 million at June 30, 2015 compared to \$9.8 million at December 31, 2014 and recognized a total tax benefit of \$0.2 million during the second quarter of 2015 and \$0.5 million during the six-month period ended June 30, 2015. Our investment in FHLBC stock totaled \$1.6 million at June 30, 2015 and \$1.8 million at December 31, 2014.

Our capital structure is comprised of equity and debt outstanding. As of June 30, 2015, our capital structure consisted of \$149.6 million in 10-year maturity senior notes maturing in 2023 (debt) and \$867.9 million of shareholders' equity. Debt outstanding comprised 14.7 percent of total capital as of June 30, 2015. Interest and fees on debt obligations totaled \$3.7 million during the first six months of 2015, the same amount as the previous year. We have incurred interest expense on debt at an average interest rate of 4.91 percent for the six-month periods ended June 30, 2015 and 2014.

We paid a quarterly cash dividend of \$0.19 per share on June 19, 2015, a \$0.01 increase over the prior quarter. We have paid dividends for 156 consecutive quarters and increased dividends in each of the last 40 years.

Our insurance subsidiaries are organized in a vertical structure with RLI Ins. as the first-level, or principal, insurance subsidiary of RLI Corp. At the holding company (RLI Corp.) level, we rely largely on dividends from our insurance company subsidiaries to meet our obligations for paying principal and interest on outstanding debt, corporate expenses and dividends to RLI Corp. shareholders. As discussed further below, dividend payments to RLI Corp. from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the insurance regulatory authorities of Illinois. As a result, we may not be able to receive dividends from

such subsidiary at times and in amounts necessary to pay desired dividends to RLI Corp. shareholders. On a GAAP basis, as of June 30, 2015, our holding company had \$867.9 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 \$53.0 million in liquid assets, which approximates 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 issuances of common stock and debt.

Ordinary dividends, which may be paid by our principal insurance subsidiary without prior regulatory approval, are subject to certain limitations based upon statutory income, surplus and earned surplus. The maximum ordinary dividend distribution from our principal insurance subsidiary in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Ins. policyholder surplus, as of December 31 of the preceding year, or the net income of RLI Ins. for the 12-month period ending December 31 of the preceding year. Ordinary dividends are further restricted by the requirement that they be paid from earned surplus. Any dividend distribution in excess of the ordinary dividend limits is deemed extraordinary and requires prior approval from the Illinois Department of Insurance. In the first six months of 2015, RLI Ins. paid a total of \$20.0 million in ordinary dividends to RLI Corp. In 2014, our principal insurance subsidiary paid ordinary dividends totaling \$185.0 million to RLI Corp. No extraordinary dividends were paid during 2014. As of June 30, 2015, \$58.4 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.

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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 82 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, 2014 Annual Report on Form 10-K.

ITEM 4. Controls and Procedures

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

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

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

PART II - OTHER INFORMATION

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

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

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

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

Our current \$100 million share repurchase program was implemented by our Board of Directors in May 2010. The repurchase program may be suspended or discontinued at any time without prior notice. During the first six months of 2015, no repurchases were made. We have not repurchased shares under this program since the third quarter of 2011. We have \$87.5 million of remaining capacity from the repurchase program.

Item 3. Defaults Upon Senior Securities - Not Applicable.

Item 4. Mine Safety Disclosures - Not Applicable.

Item 5. Other Information - Not Applicable.

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Item 6. Exhibits

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

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

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

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

Exhibit 101 XBRL-Related Documents

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SIGNATURES

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

RLI Corp.

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

Date: July 24, 2015