

RLI CORP  
Form 10-K  
February 26, 2015  
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2014

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from                      to

Commission File Number 001-09463

RLI CORP.

(Exact name of registrant as specified in its charter)

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|  |  |
|--|--|
| Illinois<br>(State or other jurisdiction of incorporation or organization)               | 37-0889946<br>(I.R.S. Employer Identification No.) |
| 9025 North Lindbergh Drive, Peoria, Illinois<br>(Address of principal executive offices) | 61615<br>(Zip Code)                                |

Registrant's telephone number, including area code (309) 692-1000

Securities registered pursuant to Section 12(b) of the Act:

|  |  |
|--|--|
| Title of each class<br>Common Stock \$1.00 par value | Name of each exchange on which registered<br>New York Stock Exchange |
|--|--|

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. 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 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 (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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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<br>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

The aggregate market value of the registrant’s common stock held by non-affiliates of the Registrant as of June 30, 2014, based upon the closing sale price of the Common Stock on June 30, 2014 as reported on the New York Stock Exchange, was \$1,729,034,102. Shares of Common Stock held directly or indirectly by each reporting officer and director along with shares held by the Company ESOP have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of the Registrant’s Common Stock, \$1.00 par value, on February 11, 2015 was 43,139,875.

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DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the Registrant's definitive Proxy Statement for the 2015 annual meeting of shareholders to be held May 7, 2015, are incorporated herein by reference into Part III of this document.

Exhibit index is located on pages 116-117 of this document, which lists documents filed as exhibits or incorporated by reference herein.

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RLI Corp.

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PART I

Item 1. Business

RLI Corp. underwrites selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance 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. CBIC re-domesticated from the state of Washington to Illinois effective December 31, 2014. We are an Illinois corporation that was organized in 1965. We have no material foreign operations.

We maintain an Internet website at <http://www.rlicorp.com>. We make available free of charge on our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed with or furnished to the Securities and Exchange Commission as soon as reasonably practicable after such materials are filed or furnished. Information contained on our website is not intended to be incorporated by reference in this annual report and you should not consider that information a part of this annual report.

As a specialty insurance company with a niche focus, we offer insurance coverages in both the specialty admitted and excess and surplus markets. Coverages in the specialty admitted market, such as our 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.

We distribute our property and casualty insurance through our wholly-owned branch offices that market to wholesale and retail producers. On a direct basis, we offer limited coverages to select insureds, as well as various reinsurance coverages, which are distributed through brokers. In addition, from time to time, we produce a limited amount of business under agreements with managing general agents under the direction of our product vice presidents.

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For the year ended December 31, 2014, the following table provides the geographic distribution of our risks insured as represented by direct premiums earned for all coverages.

| State                        | Direct Premiums Earned<br>(in thousands) | Percent of Total |   |
|------------------------------|--|------------------|---|
| California                   | \$ 127,699                               | 16.3             | % |
| New York                     | 113,061                                  | 14.5             | % |
| Florida                      | 79,579                                   | 10.2             | % |
| Texas                        | 60,640                                   | 7.8              | % |
| Washington                   | 31,213                                   | 4.0              | % |
| New Jersey                   | 24,835                                   | 3.2              | % |
| Illinois                     | 22,299                                   | 2.9              | % |
| Louisiana                    | 20,502                                   | 2.6              | % |
| Arizona                      | 19,997                                   | 2.6              | % |
| Pennsylvania                 | 19,193                                   | 2.5              | % |
| Hawaii                       | 16,163                                   | 2.1              | % |
| All Other                    | 246,459                                  | 31.3             | % |
| Total direct premiums earned | \$ 781,640                               | 100.0            | % |

In the ordinary course of business, we rely on other insurance companies to share risks through reinsurance. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk (known as facultative reinsurance). We have quota share, excess of loss and catastrophe (CAT) reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. These arrangements allow us to pursue greater diversification of business and serve to limit the maximum net loss on catastrophes and large risks. Reinsurance is subject to certain risks, specifically market risk, which affects the cost of and the ability to secure these contracts, and credit risk, which is the risk that our reinsurers may not pay on losses in a timely fashion or at all. The following table illustrates the degree to which we have utilized reinsurance during the past three years. For an expanded discussion of the impact of reinsurance on our operations, see note 5 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

| (in thousands)    | Year Ended December 31, |            |            |
|-------------------|-------------------------|------------|------------|
|                   | 2014                    | 2013       | 2012       |
| PREMIUMS WRITTEN  |                         |            |            |
| Direct & Assumed  | \$ 863,848              | \$ 843,195 | \$ 784,799 |
| Reinsurance ceded | (160,696)               | (176,873)  | (191,713)  |
| Net               | \$ 703,152              | \$ 666,322 | \$ 593,086 |
| PREMIUMS EARNED   |                         |            |            |



|                   |            |            |            |
|-------------------|------------|------------|------------|
| Direct & Assumed  | \$ 854,518 | \$ 820,460 | \$ 756,721 |
| Reinsurance ceded | (167,143)  | (189,658)  | (180,150)  |
| Net               | \$ 687,375 | \$ 630,802 | \$ 576,571 |

## SPECIALTY INSURANCE MARKET OVERVIEW

The specialty insurance market differs significantly from the standard admitted market. In the standard admitted market, insurance rates and forms are highly regulated, products and coverage are largely uniform with relatively predictable exposures and companies tend to compete for customers on the basis of price. In contrast, the specialty market provides coverage for risks that do not fit the underwriting criteria of the standard carriers. Competition tends to focus less on price and more on availability, service and other value-based considerations. While specialty market exposures may have higher insurance risks than their standard admitted market counterparts, we manage these risks to achieve higher financial returns. To reach our financial and operational goals, we must have extensive knowledge of, and expertise in, our markets. Many of our risks are underwritten on an individual basis and restricted limits, deductibles, exclusions and surcharges are employed in order to respond to distinctive risk characteristics. We operate in the specialty admitted insurance market, the excess and surplus insurance market and the specialty property and casualty reinsurance markets.

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SPECIALTY ADMITTED INSURANCE MARKET

We write business in the specialty admitted market. Most of these risks are unique and hard to place in the standard admitted market, but for marketing and regulatory reasons, they must remain with an admitted insurance company. The specialty admitted market is subject to greater 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. For 2014, our specialty admitted operations produced gross premiums written of \$525.7 million, representing approximately 61 percent of our total gross premiums for the year.

EXCESS AND SURPLUS INSURANCE MARKET

The excess and surplus market focuses on hard-to-place risks. Participating in this market allows us to underwrite non-standard risks with more flexible policy forms and unregulated premium rates. This typically results in coverages that are more restrictive and more expensive than in the standard admitted market. The excess and surplus lines regulatory environment and production model also effectively filters submission flow and matches market opportunities to our expertise and appetite. According to the 2014 edition of A.M. Best Aggregate & Averages – Property/Casualty, United States & Canada, the excess and surplus market represented approximately \$27 billion, or 5 percent, of the entire \$546 billion domestic property and casualty industry in 2014, as measured by direct premiums written. Our excess and surplus operations wrote gross premiums of \$264.5 million, or 31 percent, of our total gross premiums written in 2014.

SPECIALTY PROPERTY AND CASUALTY REINSURANCE MARKETS

We write business in the specialty property and casualty reinsurance markets. This business can be written on an individual risk (facultative) basis or on a portfolio (treaty) basis. We write contracts on an excess of loss and a proportional basis. Contract provisions are written and agreed upon between the company and its clients, other (re)insurance companies. The business is typically more volatile as a result of unique underlying exposures and excess and aggregate attachments. This business requires specialized underwriting and technical modeling. For 2014, our specialty property and casualty reinsurance operations wrote gross premiums of \$73.6 million, representing approximately 8 percent of our total gross premiums written for the year.

BUSINESS SEGMENT OVERVIEW

Our segment data is derived using the guidance set forth in Financial Accounting Standards Board Accounting Standards Codification (ASC) 280, "Segment Reporting." As prescribed by the guidance, reporting is based on the internal structure and reporting of information as it is used by management. The segments of our insurance operations are casualty, property and surety. For additional information, see note 11 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

## CASUALTY SEGMENT

### Commercial and Personal Umbrella

Our commercial umbrella coverage is principally written in excess of primary liability insurance provided by other carriers and in excess of primary liability written by us. The personal umbrella coverage is written in excess of the homeowners and automobile liability coverage provided by other carriers, except in Hawaii, where some underlying homeowners' coverage is written by us. Net premiums earned from this business totaled \$100.4 million, \$85.5 million and \$68.3 million, or 13 percent, 12 percent and 10 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

### General Liability

Our general liability business consists primarily of coverage for third-party liability of commercial insureds including manufacturers, contractors, apartments, real estate investment trusts (REITs) and mercantile. We also offer coverages in the specialized area of environmental liability for underground storage tanks, contractors and asbestos and environmental remediation specialists. Net premiums earned from our general liability business totaled \$80.8 million, \$81.4 million and \$85.0 million, or 10 percent, 12 percent and 13 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

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### Commercial Transportation

Our transportation insurance provides commercial automobile liability and physical damage insurance to local, intermediate and long haul truckers, public transportation entities and equipment dealers, along with other types of specialty commercial automobile risks. We also offer incidental, related insurance coverages including general liability, excess liability and motor truck cargo. Our highly experienced transportation underwriters produce business through independent agents and brokers nationwide. Net premiums earned from this business totaled \$58.9 million, \$50.3 million and \$34.7 million, or 8 percent, 7 percent and 5 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

### Professional Services

We offer professional liability coverages focused on providing errors and omission coverage to small-to-medium sized design, technical, computer and miscellaneous professionals. We have recently expanded our product suite to these same customers by offering a full array of multi-peril package products including general liability, property, automobile, excess liability and worker's compensation coverages. This business primarily markets its products through specialty retail agents nationwide. Net premiums earned from the professional services group totaled \$58.3 million, \$42.1 million and \$28.0 million, or 8 percent, 6 percent and 4 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

### P&C Package Business

Our P&C package business offers property and casualty insurance coverages to small contractors (ContracPac) and other small-to-medium sized "Main Street" retail businesses. The coverages included in these packages are predominantly general liability, but also have some inland marine coverages as well as commercial automobile, property and umbrella coverage. These products are predominantly marketed through retail agents. Net premiums earned from the package business totaled \$35.4 million, \$30.6 million and \$28.5 million, or 5 percent, 4 percent and 4 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

### Executive Products

We provide a suite of management liability coverages, such as directors and officers (D&O) liability insurance, fiduciary liability and fidelity coverages for a variety of low to moderate classes of risks. Our target accounts include both publicly traded companies as well as private and non-profit entities. Our publicly traded D&O appetite generally focuses on offering excess "Side A" D&O coverage (where corporations cannot indemnify the individual directors and

officers) as well as excess full coverage D&O. Additionally, we have had success rounding out our portfolio by writing fiduciary liability coverage, for both public and private entities, and primary and excess D&O coverage for private companies and non-profit organizations. Net premiums earned from the executive products business totaled \$18.9 million, \$19.1 million and \$17.2 million, or 2 percent, 3 percent and 3 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

#### Medical Professional Liability

In late 2012, we acquired Rockbridge Underwriting Agency (Rockbridge), a managing general agency that specialized in medical professional liability insurance for hard-to-place individual and group physicians. In late 2014, we expanded further into healthcare liability with a team focused on long-term care and hospital liability. Both businesses are marketed through wholesale brokers in the excess and surplus lines space. Net premiums earned from the medical professional liability business totaled \$15.9 million and \$8.6 million, or 2 percent and 1 percent of consolidated revenues for 2014 and 2013, respectively.

#### Other Casualty

We offer a variety of other smaller products in our casualty segment, including home business insurance, which provides limited liability and property coverage, on and off-site, for a variety of small business owners who work from their own home. In late 2012, we expanded our offerings within the casualty segment with the launch of coverage for security guards. We also have a number of programs that provide multiple, specialized coverages to a segmented customer base. Effective January 1, 2014, we entered into a quota share reinsurance agreement with Prime Holdings Insurance Services, Inc. (Prime). We assume general liability, excess, property and professional liability coverages on hard-to-place risks that are primarily written in the excess and surplus insurance market. Net premiums earned from these lines totaled \$13.4 million, \$6.4 million and \$6.0 million, or 2 percent, 1 percent and 1 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

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PROPERTY SEGMENT

Commercial Property

Our commercial property coverage consists primarily of excess and surplus lines and specialty insurance such as fire, earthquake and difference in conditions (DIC), which can include earthquake, wind, flood and collapse coverages. We provide insurance for a wide range of commercial and industrial risks, such as office buildings, apartments, condominiums and certain industrial and mercantile structures. Net premiums earned from the commercial property business totaled \$80.7 million, \$76.9 million and \$74.2 million, or 10 percent, 11 percent and 11 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

Marine

Our marine coverages include cargo, hull, protection and indemnity (P&I), marine liability, as well as inland marine coverages including builders' risks and contractors' equipment. Although the predominant exposures are located within the United States, there is some incidental international exposure written within these coverages. Net premiums earned from the marine business totaled \$49.2 million, \$57.1 million and \$56.4 million, or 6 percent, 8 percent and 9 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

Crop Reinsurance

We offer quota share crop reinsurance for multi-peril crop (MPCI) and crop hail exposures. Crop insurance is purchased by agricultural producers for protection against crop-related losses due to natural disasters and other perils. The MPCI program is a partnership with the U.S. Department of Agriculture (USDA). Crop insurers also issue policies that cover revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects and disease. Net premiums earned from the crop reinsurance business totaled \$28.3 million, \$31.4 million and \$24.5 million, or 4 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

Specialty Personal

We offer three specialized personal lines property products. In Hawaii, we offer a limited amount of homeowners and dwelling fire insurance through retail agents. In late 2012, we began offering a recreational vehicle product nationwide through independent agents. In 2014, we began writing surplus lines homeowners insurance for high-valued homes in

the Cape Cod, Massachusetts area, also through independent agents. Net premiums earned from specialty personal coverages totaled \$26.6 million, \$16.3 million and \$12.0 million, or 3 percent, 2 percent and 2 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

#### Property Reinsurance

We offer facultative and other treaty property reinsurance. We underwrite property facultative reinsurance for insurance companies utilizing reinsurance intermediaries. The facultative unit specializes in excess and surplus property risks requiring underwriting expertise. Perils covered range from fire and mechanical breakdown to flood and other catastrophic events. Although the predominant exposures are located within the United States, there is some incidental international exposure written by this division. This division also writes select specialty property treaties on a quota share or excess of loss basis targeting small, regional companies. These treaties are portfolio underwritten using specialized actuarial models and cover catastrophic perils of earthquake, windstorm and other weather-related events, as well as some additional losses. Net premiums earned from the property reinsurance business totaled \$12.8 million, \$15.8 million and \$27.0 million, or 2 percent, 2 percent and 4 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

#### Other Property

Our other property coverages consist of lines from which we have recently exited, including pet insurance and satellite insurance. Net premiums earned from other property coverages totaled \$0.1 million, \$2.6 million and \$8.3 million, or 1 percent or less of consolidated revenues for 2014, 2013 and 2012, respectively.

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SURETY SEGMENT

Miscellaneous

Our miscellaneous surety coverage includes small bonds for businesses and individuals written through approximately 10,000 independent insurance agencies throughout the United States. Examples of these types of bonds are license and permit, notary and court bonds. These bonds are usually individually underwritten and utilize extensive automation tools for the underwriting and bond delivery to our agents. Net premiums earned from miscellaneous surety coverages totaled \$39.0 million, \$38.1 million and \$39.3 million, or 5 percent, 5 percent and 6 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

Contract

We offer bonds for small-to-medium sized contractors throughout the United States, underwritten on an account basis. Typically, these are performance and payment bonds for individual construction contracts. These bonds are marketed through a select number of insurance agencies that have surety and construction expertise. We also offer bonds for small and emerging contractors that are reinsured through the Federal Small Business Administration. Net premiums earned from contract surety coverages totaled \$26.6 million, \$27.2 million and \$26.3 million, or 3 percent, 4 percent and 4 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

Commercial

We offer a large variety of commercial surety bonds for medium-to-large businesses across a broad spectrum of industries. These risks are underwritten on an account basis with the ability to write bonded aggregations up to \$90 million. This coverage is marketed through a select number of regional and national brokers with surety expertise. Net premiums earned from commercial surety coverages totaled \$25.8 million, \$23.1 million and \$22.1 million, or 3 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

Oil and Gas

Our oil and gas surety coverages provide commercial surety bonds for the energy, petrochemical and refining industries. These risks are primarily underwritten on an account basis and are primarily marketed through insurance producers with expertise in these industries. Net premiums earned from oil and gas surety coverages totaled \$16.1



million, \$18.2 million and \$18.7 million, or 2 percent, 3 percent and 3 percent of consolidated revenues for 2014, 2013 and 2012, respectively.

## MARKETING AND DISTRIBUTION

We distribute our coverages primarily through branch offices throughout the country that market to wholesale and retail brokers and through independent agents. We also market through agencies and e-commerce channels.

## BROKERS

The largest volume of broker-generated premium is in our commercial property, general liability, commercial surety, commercial umbrella, commercial automobile, medical professional liability and specialty facultative and treaty reinsurance coverages. This business is produced through independent wholesale, retail and reinsurance brokers.

## INDEPENDENT AGENTS

Our surety segment offers its business through a variety of independent agents. Additionally, we target classes of insurance, such as home business and personal umbrella, through independent agents. Homeowners and dwelling fire is produced through independent agents in Hawaii. Several of these programs involve detailed eligibility criteria, which are incorporated into strict underwriting guidelines and prequalification of each risk using a system accessible by the independent agent. The independent agent cannot bind the risk unless they receive approval from our underwriters or through our automated system.

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UNDERWRITING AGENTS

We contract with certain underwriting agencies, which have limited authority to bind or underwrite business on our behalf. The underwriting agreements involve strict underwriting guidelines and the agents are subject to audits upon request. These agencies may receive some compensation through contingent profit commission.

E-COMMERCE AND/OR DIRECT

We are actively employing e-commerce to produce and efficiently process and service business including home businesses, small commercial and personal umbrella risks and surety bonding. On a direct basis, we also assume premium on various reinsurance treaties.

COMPETITION

Our specialty property and casualty insurance subsidiaries are part of a very competitive industry that is cyclical and historically characterized by periods of high premium rates and shortages of underwriting capacity followed by periods of severe competition and excess underwriting capacity. Within the United States alone, approximately 2,700 companies actively market property and casualty coverages. Our primary competitors in the casualty segment include ACE, Arch, Aspen, Baldwin & Lyons, Chubb, CNA, Endurance, Great American, Great West, Lancer, Markel, Navigators, USLI, Travelers and Zurich. Primary competitors in the property segment include ACE, Arch, Aspen, CNA, Crum & Forster, Endurance, Lexington, Markel and Travelers. Primary competitors in the surety segment are ACE, Arch, CNA, Hartford, HCC, Liberty, North American Specialty and Travelers. The combination of coverages, service, pricing and other methods of competition vary from line to line. Our principal methods of meeting this competition are innovative coverages, marketing structure and quality service to the agents and policyholders at a fair price. We compete favorably, in part, because of our sound financial base and reputation, as well as our broad, geographic penetration in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. In the casualty, property and surety areas, we have experienced underwriting specialists in our branch and home offices. We continue to maintain our underwriting and marketing standards by not seeking market share at the expense of earnings. We have a track record of withdrawing from markets when conditions become overly adverse, and we offer new coverages and programs where the opportunity exists to provide needed insurance coverage with exceptional service on a profitable basis.

FINANCIAL STRENGTH RATINGS

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A.M. Best financial strength ratings for the industry range from “A++” (Superior) to “F” (In liquidation) with some companies not being rated. Standard & Poor’s financial strength ratings for the industry range from “AAA” (Extremely strong) to “R” (Regulatory action). Moody’s financial strength ratings for the industry range from “Aaa” (Exceptional) to “C” (Lowest). The following table illustrates the range of ratings assigned by each of the three major rating companies that has issued a financial strength rating on our insurance companies:

| A.M. Best                 |                              | Standard & Poor’s |                   | Moody’s |                       |
|---------------------------|------------------------------|-------------------|-------------------|---------|-----------------------|
| SECURE                    |                              | SECURE            |                   | STRONG  |                       |
| A++, A+                   | Superior                     | AAA               | Extremely strong  | Aaa     | Exceptional           |
| A, A-                     | Excellent                    | AA                | Very strong       | Aa      | Excellent             |
| B++, B+                   | Very good                    | A                 | Strong            | A       | Good                  |
|                           |                              | BBB               | Good              | Baa     | Adequate              |
|                           |                              |                   |                   |         |                       |
| VULNERABLE                |                              | VULNERABLE        |                   | WEAK    |                       |
| B, B-                     | Fair                         | BB                | Marginal          | Ba      | Questionable          |
| C++, C+                   | Marginal                     | B                 | Weak              | B       | Poor                  |
| C, C-                     | Weak                         | CCC               | Very weak         | Caa     | Very poor             |
| D                         | Poor                         | CC                | Extremely weak    | Ca      | Extremely poor        |
| E                         | Under regulatory supervision | R                 | Regulatory action | C       | Lowest                |
| F                         | In liquidation               |                   |                   |         |                       |
| S                         | Rating suspended             |                   |                   |         |                       |
| Within-category modifiers |                              |                   | +, -              |         | 1,2,3 (1 high, 3 low) |

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Publications of A.M. Best, Standard & Poor's and Moody's indicate that "A" and "A+" ratings are assigned to those companies that, in their opinion, have achieved excellent overall performance compared to the standards they've established and have a strong ability to meet their obligations to policyholders over a long period of time. In evaluating a company's financial and operating performance, each of the firms review the company's profitability, leverage and liquidity, as well as the company's spread of risk, the quality and appropriateness of its reinsurance, the quality and diversification of its assets, the adequacy of its policy and loss reserves, the adequacy of its surplus, its capital structure, its risk management practices and the experience and objectives of its management. These ratings are based on factors relevant to policyholders, agents, insurance brokers and intermediaries and are not specifically related to securities issued by the company.

At December 31, 2014, the following ratings were assigned to our insurance companies:

|   |              |
|---|--------------|
| A.M. Best   |              |
| RLI Ins., Mt. Hawley, RIC and CBIC* (group-rated) | A+, Superior |
| Standard & Poor's**                               |              |
| RLI Ins. and Mt. Hawley                           | A+, Strong   |
| Moody's   |              |
| RLI Ins., Mt. Hawley and RIC                      | A2, Good     |

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\*CBIC is only rated by A.M. Best

\*\*Standard & Poor's does not rate RIC

For A.M. Best, Standard & Poor's and Moody's, the financial strength ratings represented above are affirmations of previously assigned ratings. A.M. Best, in addition to assigning a financial strength rating, also assigns financial size categories. In June 2014, RLI Ins., Mt. Hawley, RIC and CBIC, which are collectively rated as a group, were assigned a financial size category of "XI" (adjusted policyholders' surplus of between \$750 million and \$1 billion). As of December 31, 2014, the policyholders' statutory surplus of RLI Insurance Group totaled \$849.3 million. This would keep the group in A.M. Best's financial size category "XI".

## REINSURANCE

We reinsure a portion of our insurance exposure, paying or ceding to the reinsurer a portion of the premiums received on such policies. Earned premiums ceded to non-affiliated reinsurers totaled \$167.1 million, \$189.7 million and \$180.2 million in 2014, 2013 and 2012, respectively. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. We use reinsurance as an alternative to using our own

capital to take risks and reduce volatility. Retention levels are adjusted each year to maintain a balance between the growth in surplus and the cost of reinsurance. Although reinsurance does not legally discharge an insurer from its primary liability for the full amount of the policies, it does make the assuming reinsurer liable to the insurer to the extent of the insurance ceded.

Reinsurance is subject to certain risks, specifically market risk (which affects the cost and ability to secure reinsurance contracts) and credit risk (which relates to the ability to collect from the reinsurer on our claims). We purchase reinsurance from a number of financially strong reinsurers. We evaluate reinsurers' ability to pay based on their financial results, level of surplus, financial strength ratings and other risk characteristics. A reinsurance committee, comprised of senior management, approves our security guidelines and reinsurer usage. More than 96 percent of our reinsurance recoverables are due from companies with financial strength ratings of "A" or better by A.M. Best and Standard & Poor's rating services. For more information regarding our largest reinsurers, see note 5 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

We utilize both treaty and facultative reinsurance coverage for our risks. Treaty coverage refers to a reinsurance contract that is applied to a group or class of business where all the risks written meet the criteria for that class. Facultative coverage is applied to individual risks as opposed to a group or class of business. It is used for a variety of reasons, including supplementing the limits provided by the treaty coverage or covering risks or perils excluded from treaty reinsurance.

Much of our reinsurance is purchased on an excess of loss basis. Under an excess of loss arrangement, we retain losses on a risk up to a specified amount and the reinsurers assume any losses above that amount. We may choose to participate in the reinsurance layers purchased by retaining a percentage of the layer. It is common to find conditions in excess of loss covers

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such as occurrence limits, aggregate limits and reinstatement premium charges. Occurrence limits cap our recovery for multiple losses caused by the same event. Aggregate limits cap our recovery for all losses ceded during the contract term. We may be required to pay additional premium to reinstate or have access to use the reinsurance limits for potential future recoveries during the same contract year. Many property and surety treaties include reinstatement provisions which require us, in certain circumstances, to pay reinstatement premiums after a loss has occurred in order to preserve coverage.

Excluding CAT reinsurance, the following table summarizes the reinsurance treaty coverage currently in effect:

| (in millions)                                  |                |              |                        |                          |                    |
|--|----------------|--------------|------------------------|--------------------------|--------------------|
| Product Line(s) Covered                        | Contract Type  | Renewal Date | First-Dollar Retention | Per Risk Limit Purchased | Maximum Retention* |
| General liability                              | Excess of Loss | 1/1          | \$ 1.0                 | \$ 4.0                   | \$ 1.4             |
| Commercial umbrella and excess                 | Excess of Loss | 1/1          | 1.0                    | 9.0                      | 1.9                |
| Personal umbrella and eXS                      | Excess of Loss | 1/1          | 1.0                    | 4.0                      | 1.4                |
| Commercial transportation                      | Excess of Loss | 1/1          | 0.5                    | 4.5                      | 1.0                |
| Executive products                             | Quota Share    | 7/1          | N/A                    | 25.0                     | 8.8                |
| Professional services - professional liability | Excess of Loss | 4/1          | 1.0                    | 9.0                      | 3.3                |
| Multi-line                                     | Excess of Loss | 1/1          | 0.5                    | 10.5                     | 1.6                |
| Multi-line workers comp                        | Excess of Loss | 1/1          | 1.0                    | 10.0                     | 2.0                |
| Medical professional liability                 | Excess of Loss | 12/1         | 0.5                    | 1.5                      | 1.3                |
| Property                                       | Excess of Loss | 1/1          | 1.0                    | 24.0                     | 1.6                |
| Marine   | Excess of Loss | 6/1          | 2.0                    | 28.0                     | 2.0                |
| Surety   | Excess of Loss | 4/1          | 2.0                    | 63.0                     | 8.7 **             |
| CBIC Surety                                    | Excess of Loss | 4/1          | 0.5                    | 24.5                     | 3.4                |

\*Maximum retention includes first-dollar retention plus any co-participation we retain through the reinsurance tower.

\*\*A limited number of commercial and oil & gas surety accounts are permitted to exceed the \$65.0 million limit. These accounts are subject to additional levels of review and are monitored on a monthly basis.

At each renewal, we consider any plans to change the underlying insurance coverage we offer, as well as updated loss activity, the level of RLI Insurance Group's surplus, changes in our risk appetite and the cost and availability of

reinsurance treaties. In the last renewal cycle, we maintained similar retentions on most lines of business.

#### PROPERTY REINSURANCE — CATASTROPHE COVERAGE

Our property CAT reinsurance reduces the financial impact of a CAT event involving multiple claims and policyholders. Reinsurance limits purchased fluctuate due to changes in the amount of exposure we insure, reinsurance costs, insurance company surplus levels and our risk appetite. In addition, we monitor the expected rate of return for each of our CAT lines of business. At high rates of return, we grow the book of business and may purchase additional reinsurance to increase our capacity. As the rate of return decreases, we shrink the book and may purchase less reinsurance as this capacity is unnecessary. Our reinsurance coverage for the last few years follows:

#### Catastrophe Coverages

(in millions)

|                           | 2015      |        | 2014      |        | 2013      |        | 2012      |        |
|---------------------------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|
|                           | First-    | Dollar | First-    | Dollar | First-    | Dollar | First-    | Dollar |
|                           | Retention | Limit  | Retention | Limit  | Retention | Limit  | Retention | Limit  |
| California Earthquake     | \$ 25     | 300    | \$ 25     | 300    | \$ 25     | 300    | \$ 25     | 300    |
| Non-California Earthquake | 25        | 325    | 25        | 325    | 20        | 330    | 20        | 330    |
| Other Perils              | 25        | 225    | 25        | 225    | 20        | 230    | 20        | 230    |

These CAT limits are in addition to the per-occurrence coverage provided by facultative and other treaty coverages. We have participated in the CAT layers purchased by retaining a percentage of each layer throughout this period. Our participation

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has varied based on price and the amount of risk transferred by each layer. In 2015 and 2014, all layers of the treaty include one prepaid reinstatement.

In 2013 and prior, our CAT program included one prepaid reinstatement for two layers of coverage, up to \$100.0 million, for a CAT event other than a California earthquake. If a loss had occurred above that level, reinstatement would have been purchased for the remaining limits recovered. For a California earthquake, there was a prepaid reinstatement for the \$50.0 million excess \$50.0 million layer (placed at 75 percent for 2013 and 2012) and a reinstatement would have been purchased subsequent to an event for the remaining reinsurance coverage.

Our property CAT program continues to be on an excess of loss basis. It attaches after all other reinsurance has been considered. Although covered in one program, limits and attachment points differ for California earthquakes and all other perils. The following charts use information from our CAT modeling software to illustrate our pre-tax net retention resulting from particular events that would generate the gross losses shown in the table:

## Catastrophe - California Earthquake

(in millions)

| Projected<br>Gross Loss<br>\$ | 2015            |               | 2014            |               | 2013            |               |
|-------------------------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|
|                               | Ceded<br>Losses | Net<br>Losses | Ceded<br>Losses | Net<br>Losses | Ceded<br>Losses | Net<br>Losses |
| 50                            | \$ 28           | \$ 22         | \$ 28           | \$ 22         | \$ 28           | \$ 22         |
| 100                           | 72              | 28            | 70              | 30            | 70              | 30            |
| 200                           | 163             | 37            | 160             | 40            | 155             | 45            |
| 350                           | 302             | 48            | 298             | 52            | 287             | 63            |

## Catastrophe - Other (Earthquake outside of California, Wind, Other)

(in millions)

| Projected<br>Gross Loss<br>\$ | 2015            |               | 2014            |               | 2013            |               |
|-------------------------------|-----------------|---------------|-----------------|---------------|-----------------|---------------|
|                               | Ceded<br>Losses | Net<br>Losses | Ceded<br>Losses | Net<br>Losses | Ceded<br>Losses | Net<br>Losses |
| 25                            | \$ 5            | \$ 20         | \$ 5            | \$ 20         | \$ 8            | \$ 17         |



|     |     |    |     |    |     |    |
|-----|-----|----|-----|----|-----|----|
| 50  | 21  | 29 | 19  | 31 | 23  | 27 |
| 100 | 60  | 40 | 56  | 44 | 61  | 39 |
| 250 | 192 | 58 | 188 | 62 | 185 | 65 |

In the above table, projected losses for 2015 were estimated based on our exposure as of December 31, 2014, utilizing the treaty structure in place as of January 1, 2015. All previous years were estimated similarly by utilizing the exposure at the end of each respective year and the treaty structure in place at the start of the following year.

The previous tables were generated using theoretical probabilities of events occurring in areas where our portfolio of currently in-force policies could generate the level of loss illustrated. Actual results could vary significantly from these tables as the actual nature or severity of a particular event cannot be predicted with any reasonable degree of accuracy. Reinsurance limits are purchased based on the anticipated losses from large events. The largest losses shown above are possible, but have a low probability of actually occurring. However, there is a remote chance that a larger event could occur. If the actual event losses are larger than anticipated, we could retain additional losses above the limit of our CAT reinsurance.

We continuously monitor and quantify our exposure to catastrophes including earthquakes, hurricanes, floods, convective storms, terrorist acts and other aggregating events. In the normal course of business, we manage our concentrations of exposures to catastrophic events, primarily by limiting concentrations of locations insured to acceptable levels and by purchasing reinsurance. Exposure and coverage detail is recorded for each risk location. We quantify and monitor the total policy limit insured in each geographical region. In addition, we use third-party CAT exposure models and an internally developed analysis to assess each risk to ensure we include an appropriate charge for assumed CAT risks. CAT exposure modeling is inherently uncertain due to the model's reliance on an infrequent observation of actual events and exposure data, increasing the importance of capturing accurate policy coverage data. The model results are used both in the underwriting analysis of individual risks and at a corporate level for the aggregate book of CAT-exposed business. From both perspectives, we consider the potential loss produced by individual events that represent moderate-to-high loss potential at varying probabilities and magnitudes. In calculating potential losses, we select appropriate assumptions including, but not limited to,

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loss amplification and loss adjustment expense. We establish risk tolerances at the portfolio level based on market conditions, the level of reinsurance available, changes to the assumptions in the CAT models, rating agency capital constraints, underwriting guidelines and coverages and internal preferences. Our risk tolerances for each type of CAT, and for all perils in aggregate, change over time as these internal and external conditions change. We are required to report to the rating agencies estimated loss to a single event that could include all potential earthquakes and hurricanes contemplated by the CAT modeling software. This reported loss includes the impact of insured losses based on the estimated frequency and severity of potential events, loss adjustment expense, reinstatements paid after the loss, reinsurance recoveries and taxes. Based on the CAT reinsurance treaty purchased on January 1, 2015, there is a 99.6 percent likelihood that the loss will be less than 9.3 percent of policyholders' surplus as of December 31, 2014. Our exposure to CAT losses has been relatively stable based on multiple views of risk including policy counts, policy limits insured and modeled losses based on multiple CAT models. The exposure levels are still well within our tolerances for this risk.

LOSSES AND SETTLEMENT EXPENSES

OVERVIEW

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

Net loss and loss adjustment reserves by product line at year-end 2014 and 2013 are illustrated in the following table. LAE is classified in the table as either allocated loss adjustment expense (ALAE) or unallocated loss adjustment expense (ULAE). ALAE refers to estimates of claim settlement expenses that can be identified with a specific claim or case, while ULAE cannot be identified with a specific claim. For a detailed discussion of loss reserves, refer to our critical accounting policy in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

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| (as of December 31, in thousands)           | 2014       |            |            | 2013       |            |            |
|---|------------|------------|------------|------------|------------|------------|
| Product Line                                | Case       | IBNR       | Total      | Case       | IBNR       | Total      |
| Casualty segment net loss and ALAE reserves |            |            |            |            |            |            |
| Commercial umbrella                         | \$ 7,491   | \$ 56,167  | \$ 63,658  | \$ 4,893   | \$ 35,287  | \$ 40,180  |
| Personal umbrella                           | 22,287     | 26,527     | 48,814     | 19,466     | 23,546     | 43,012     |
| General liability                           | 103,327    | 139,824    | 243,151    | 126,203    | 151,096    | 277,299    |
| Commercial transportation                   | 53,620     | 19,060     | 72,680     | 49,172     | 12,200     | 61,372     |
| Executive products                          | 11,619     | 42,176     | 53,795     | 19,023     | 34,363     | 53,386     |
| Professional services                       | 11,034     | 49,380     | 60,414     | 8,082      | 34,060     | 42,142     |
| P&C package business                        | 10,243     | 25,910     | 36,153     | 9,622      | 28,295     | 37,917     |
| Other casualty                              | 12,533     | 20,741     | 33,274     | 7,390      | 17,028     | 24,418     |
| Property segment net loss and ALAE reserves |            |            |            |            |            |            |
| Marine                                      | 14,436     | 19,076     | 33,512     | 21,649     | 17,764     | 39,413     |
| Crop reinsurance                            | 276        | 23,809     | 24,085     | 24,668     | 5,017      | 29,685     |
| Property reinsurance                        | 5,749      | 6,580      | 12,329     | 8,560      | 3,929      | 12,489     |
| Commercial property                         | 4,216      | 2,982      | 7,198      | 8,307      | 5,351      | 13,658     |
| Specialty personal                          | 1,321      | 1,980      | 3,301      | 1,470      | 1,000      | 2,470      |
| Other property                              | 60         | 929        | 989        | 42         | 785        | 827        |
| Surety segment net loss and ALAE reserves   |            |            |            |            |            |            |
| Miscellaneous                               | 535        | 4,654      | 5,189      | 1,185      | 4,557      | 5,742      |
| Contract and commercial                     | (339)      | 16,684     | 16,345     | (3,035)    | 18,436     | 15,401     |
| Oil and gas                                 | 947        | 2,673      | 3,620      | 1,329      | 2,242      | 3,571      |
| Latent liability net loss and ALAE reserves | 10,817     | 16,368     | 27,185     | 15,357     | 18,107     | 33,464     |
| Total net loss and ALAE reserves            | \$ 270,172 | \$ 475,520 | \$ 745,692 | \$ 323,383 | \$ 413,063 | \$ 736,446 |
| ULAE reserves                               | —          | 40,242     | 40,242     | —          | 38,063     | 38,063     |
| Total net loss and LAE reserves             | \$ 270,172 | \$ 515,762 | \$ 785,934 | \$ 323,383 | \$ 451,126 | \$ 774,509 |

Following is a table of significant risk factors involved in estimating losses grouped by major product line. We distinguish between loss ratio risk and reserve estimation risk. Loss ratio risk refers to the possible dispersion of loss ratios from year to year due to inherent volatility in the business, such as high severity or aggregating exposures. Reserve estimation risk recognizes the difficulty in estimating a given year's ultimate loss liability. As an example, our property CAT business (included below in "Other property") has significant variance in year-over-year results; however its reserving estimation risk is relatively moderate.

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## Significant Risk Factors

| Product line                   | Length of Reserve Tail | Emergence patterns relied upon  | Other risk factors   | Expected loss ratio variability | Reserve estimation variability |
|--------------------------------|------------------------|---------------------------------|--|---------------------------------|--------------------------------|
| Commercial Umbrella            | Long                   | Internal                        | Low frequency<br>High severity<br>Loss trend volatility<br>Rapid growth<br>Unforeseen tort potential<br>Exposure changes/mix | High                            | High                           |
| Personal Umbrella              | Medium                 | Internal                        | Low frequency  | Medium                          | Medium                         |
| General Liability              | Long                   | Internal                        | Exposure growth/mix<br>Unforeseen tort potential   | Medium                          | High                           |
| Medical Professional Liability | Long                   | External                        | High severity<br>Exposure changes/mix<br>Unforeseen tort potential<br>Small volume   | High                            | High                           |
| Commercial Transportation      | Medium                 | Internal                        | High severity<br>Exposure growth/mix   | Medium                          | Medium                         |
| Executive Products             | Long                   | Internal & significant external | Low frequency<br>High severity<br>Loss trend volatility<br>Economic volatility<br>Unforeseen tort potential<br>Small volume  | High                            | High                           |
| Professional Services          | Long                   | External                        | Exposure growth<br>Highly varied exposures<br>Loss trend volatility<br>Unforeseen tort potential<br>Small volume             | High                            | High                           |

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|  |        |                     |  |        |        |
|--|--------|---------------------|--|--------|--------|
| P&C package<br>business                            | Long   | Internal            | Exposure growth/mix<br>Unforeseen tort potential   | Medium | High   |
| Other casualty                                     | Medium | Internal & external | Small volume   | Medium | Medium |
| Marine   | Medium | Internal & external | Small volume<br>Exposure changes/mix   | High   | High   |
| Crop<br>reinsurance                                | Short  | External            | Weather, yield and price volatility<br>CAT aggregation exposure<br>Unique inuring<br>reinsurance features            | Medium | Medium |
| Property<br>reinsurance                            | Medium | External            | New business<br>CAT aggregation exposure<br>Low frequency<br>High severity<br>Exposure growth/mix<br>Reporting delay | High   | Medium |
| Other property                                     | Short  | Internal            | CAT aggregation exposure<br>Low frequency<br>High severity   | High   | Medium |
| Surety   | Medium | Internal            | Economic volatility<br>Uniqueness of exposure  | Medium | Medium |
| Runoff<br>including<br>asbestos &<br>environmental | Long   | Internal & external | Loss trend volatility<br>Mass tort/latent exposure   | High   | High   |

A full analysis of our loss reserves takes place at least semi-annually. The purpose of this analysis is to provide validation of our carried loss reserves. Estimates of the expected value of the unpaid loss and LAE are derived using actuarial

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methodologies. These estimates are then compared to the carried loss reserves to determine the appropriateness of the current reserve balance.

The methodologies we have chosen to incorporate are a function of data availability and are reflective of our own book of business. From time to time, we evaluate the need to add supplementary methodologies. New methods are incorporated if it is believed that they improve the estimate of our ultimate loss and LAE liability. This occurred in 2011 as we initiated some supplemental calculations for a sub-segment experiencing apparent changes in case reserve practices. All of the actuarial methods eventually converge to the same estimate as an accident year matures. Our core methodologies are listed below with a short description and their relative strengths and weaknesses:

**Paid Loss Development** — Historical payment patterns for prior claims are used to estimate future payment patterns for current claims. These patterns are applied to current payments by accident year to yield an expected ultimate loss.

**Strengths:** The method reflects only the claim dollars that have been paid and is not subject to case-basis reserve changes or changes in case reserve practices.

**Weaknesses:** External claims environment changes can impact the rate at which claims are settled and losses paid (e.g. increase in attorney involvement or legal precedent). Adjustments to reflect changes in payment patterns on a prospective basis are difficult to quantify. For losses that have occurred recently, payments can be minimal and thus early estimates are subject to significant instability.

**Incurred Loss Development** — Historical case-incurred patterns (paid losses plus case reserves) for past claims are used to estimate future case-incurred amounts for current claims. These patterns are applied to current case-incurred losses by accident year to yield an expected ultimate loss.

**Strengths:** Losses are reported more quickly than paid, therefore, the estimates stabilize sooner. The method reflects more information in the analysis than the paid loss development method.

**Weaknesses:** Method involves additional estimation risk if significant changes to case reserving practices have occurred.

**Case Reserve Development** — Patterns of historical development in reported losses relative to historical case reserves are determined. These patterns are applied to current case reserves by accident year and the result is combined with

paid losses to yield an expected ultimate loss.

**Strengths:** Like the incurred development method, this method benefits from using the additional information available in case reserves that is not available from paid losses only. It also can provide a more reasonable estimate than other methods when the proportion of claims still open for an accident year is unusually high or low.

**Weaknesses:** It is subject to the risk of changes in case reserving practices or philosophy. It may provide unstable estimates when an accident year is immature and more of the IBNR is expected to come from unreported claims rather than development on reported claims and when accident years are very mature with infrequent case reserves.

**Expected Loss Ratio** — Historical loss ratios, in combination with projections of frequency and severity trends, as well as estimates of price and exposure changes, are analyzed to produce an estimate of the expected loss ratio for each accident year. The expected loss ratio is then applied to the earned premium for each year to estimate the expected ultimate losses. The current accident year expected loss ratio is also the prospective loss and ALAE ratio used in our initial IBNR generation process.

**Strengths:** Reflects an estimate independent of how losses are emerging on either a paid or a case reserve basis. This method is particularly useful in the absence of historical development patterns or where losses take a long time to emerge.

**Weaknesses:** Ignores how losses are actually emerging and thus produces the same estimate of ultimate loss regardless of favorable/unfavorable emergence.

**Paid and Incurred Bornhuetter/Ferguson (BF)** — This approach blends the expected loss ratio method with either the paid or incurred loss development method. In effect, the BF methods produce weighted average indications for each accident year. As an example, if the current accident year for commercial automobile liability is estimated to be 20 percent paid, then the paid

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loss development method would receive a weight of 20 percent and the expected loss ratio method would receive an 80 percent weight. Over time, this method will converge with the ultimate estimated by the respective loss development method.

**Strengths:** Reflects actual emergence that is favorable/unfavorable, but assumes remaining emergence will continue as previously expected. Does not overreact to the early emergence (or lack of emergence) where patterns are most unstable.

**Weaknesses:** Could potentially understate favorable or unfavorable development by putting weight on the expected loss ratio.

In most cases, multiple estimation methods will be valid for the particular facts and circumstances of the claim liabilities being evaluated. Each estimation method has its own set of assumption variables and its own advantages and disadvantages, with no single estimation method being better than the others in all situations, and no one set of assumption variables being meaningful for all product line components. The relative strengths and weaknesses of the particular estimation methods, when applied to a particular group of claims, can also change over time. Therefore, the weight given to each estimation method will likely change by accident year and with each evaluation.

The actuarial central estimates typically follow a progression that places significant weight on the BF methods when accident years are younger and claims emergence is immature. As accident years mature and claims emerge over time, increasing weight is placed on the incurred development method, the paid development method and the case reserve development method. For product lines with faster loss emergence, the progression to greater weight on the incurred and paid development methods occurs more quickly.

For our long and medium-tail products, the BF methods are typically given the most weight for the first 36 months of evaluation. These methods are also predominant for the first 12 months of evaluation for short-tail lines. Beyond these time periods, our actuaries apply their professional judgment when weighting the estimates from the various methods deployed but place significant reliance on the expected stage of development in normal circumstances.

Judgment can supersede this natural progression if risk factors and assumptions change, or if a situation occurs that amplifies a particular strength or weakness of a methodology. Extreme projections are critically analyzed and may be adjusted, given less credence or discarded altogether. Internal documentation is maintained that records any substantial changes in methods or assumptions from one loss reserve study to another.

RESERVE SENSITIVITIES



There are three major parameters that have significant influence on our actuarial estimates of ultimate liabilities by product. They are the actual losses that are reported, the expected loss emergence pattern and the expected loss ratios used in the analyses. If the actual losses reported do not emerge as expected, it may cause us to challenge all or some of our previous assumptions. We may change expected loss emergence patterns, the expected loss ratios used in our analysis and/or the weights we place on a given actuarial method. The impact will be much greater and more leveraged for products with longer emergence patterns. Our general liability product is an example of a product with a relatively long emergence pattern. We have constructed a chart below that illustrates the sensitivity of our general liability reserve estimates to these key parameters. We believe the scenarios to be reasonable as similar favorable variations have occurred in recent years. For example, while our general liability emergence has ranged from 4 percent to 29 percent favorable over the last three years, our emergence for all products combined, excluding general liability, has ranged from 11 percent to 23 percent favorable. The numbers below are the changes in estimated ultimate loss and ALAE in millions of dollars as of December 31, 2014, resulting from the change in the parameters shown. These parameters were applied to a general liability net loss and LAE reserve balance of \$243.2 million at December 31, 2014, in addition to associated ULAE and latent liability reserves.

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| (in millions)  | Result from favorable<br>change in parameter | Result from unfavorable<br>change in the parameter |
|--|--|--|
| +/-5 point change in expected loss ratio for all accident years  | \$ (8.2)                                     | \$ 8.2   |
| +/-10% change in expected emergence patterns   | \$ (7.1)                                     | \$ 6.9   |
| +/-30% change in actual loss emergence over a calendar year  | \$ (15.2)                                    | \$ 15.2  |
| Simultaneous change in expected loss ratio (5pts), expected emergence patterns (10%), and actual loss emergence (30%). | \$ (29.9)                                    | \$ 30.7  |

There are often significant inter-relationships between our reserving assumptions that have offsetting or compounding effects on the reserve estimate. Thus, in almost all cases, it is impossible to discretely measure the effect of a single assumption or construct a meaningful sensitivity expectation that holds true in all cases. The scenario above is representative of general liability, one of our largest and longest-tailed products. It is unlikely that all of our products would have variations as wide as illustrated in the example. It is also unlikely that all of our products would simultaneously experience favorable or unfavorable loss development in the same direction or at their extremes during a calendar year. Because our portfolio is made up of a diversified mix of products, there would ordinarily be some offsetting favorable and unfavorable emergence by product as actual losses start to emerge and our loss estimates become more reliable.

It is difficult for us to predict whether the favorable loss development observed in 2004 through 2014 will continue for any of our products in the future. We have reviewed historical data detailing the development of our total balance sheet reserves and changes in accident year loss ratios relative to original estimates. Based on this analysis and our understanding of loss reserve uncertainty, we believe fluctuations will occur in our estimate of ultimate reserve liabilities over time. Over the next calendar year, given our current exposure level and product mix, it would be reasonably likely for us to observe loss reserve development relating to prior years' estimates across all of our products ranging from approximately 10 percent (\$79 million) favorable to 3 percent (\$24 million) unfavorable.

**HISTORICAL LOSS AND LAE DEVELOPMENT**

The following table presents the development of our balance sheet reserves from 2004 through 2014. The top line of the table shows the net reserves at the balance sheet date for each of the indicated periods. This represents the estimated amount of net losses and settlement expenses arising in all prior years that are unpaid at the balance sheet date, including losses that had been incurred but not yet reported to us. The lower portion of the table shows the re-estimated amount of the previously recorded net reserves based on experience as of the end of each succeeding year, as well as the re-estimated previously recorded gross reserves as of December 31, 2014. The estimate changes as more information becomes known about the frequency and severity of claims for individual periods.

Favorable loss and LAE reserve development can be observed in the table for all years ending on both a net and gross basis. As the table displays, variations exist between our cumulative loss experience on a gross and net basis due to the application of reinsurance. On certain products, our net retention (after applying reinsurance) is significantly less than our gross retention (before applying reinsurance). These differences in retention can cause a significant (leveraged) difference between loss reserve development on a net and gross basis. As the relationship of our gross to net retention changes over time, re-estimation of loss reserves will result in variations between our cumulative loss experience on a gross and net basis.

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Ended December 31,

| or     | 2005         | 2006         | 2007         | 2008         | 2009         | 2010         | 2011         | 2012         | 2013         |
|--------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| ,419   | \$ 738,657   | \$ 793,106   | \$ 774,928   | \$ 809,027   | \$ 810,068   | \$ 819,780   | \$ 796,909   | \$ 798,599   | \$ 798,599   |
| ,870   | 154,446      | 162,450      | 161,484      | 160,460      | 147,677      | 177,862      | 200,169      | 226,361      | 226,361      |
| ,734   | 270,210      | 275,322      | 267,453      | 269,740      | 259,456      | 308,702      | 339,847      | 363,884      | 363,884      |
| ,284   | 353,793      | 348,018      | 343,777      | 348,188      | 352,106      | 407,351      | 445,709      |              |              |
| ,417   | 399,811      | 394,812      | 393,157      | 404,112      | 421,176      | 479,641      |              |              |              |
| ,002   | 431,959      | 422,835      | 424,991      | 446,796      | 470,168      |              |              |              |              |
| ,186   | 447,415      | 443,091      | 453,587      | 480,534      |              |              |              |              |              |
| ,414   | 461,254      | 461,675      | 474,769      |              |              |              |              |              |              |
| ,321   | 475,620      | 477,611      |              |              |              |              |              |              |              |
| ,143   | 486,801      |              |              |              |              |              |              |              |              |
| ,647   |              |              |              |              |              |              |              |              |              |
| ,946   | 695,254      | 687,927      | 712,590      | 742,451      | 726,825      | 763,225      | 732,091      | 726,096      | 726,096      |
| ,709   | 636,356      | 637,117      | 658,109      | 655,838      | 632,697      | 671,210      | 695,792      | 693,032      | 693,032      |
| ,181   | 599,420      | 601,939      | 605,111      | 596,476      | 608,260      | 644,663      | 680,458      |              |              |
| ,795   | 576,319      | 569,806      | 560,565      | 583,439      | 588,355      | 637,278      |              |              |              |
| ,803   | 556,836      | 540,895      | 552,558      | 570,613      | 582,805      |              |              |              |              |
| ,321   | 539,639      | 539,654      | 545,223      | 569,388      |              |              |              |              |              |
| ,462   | 540,298      | 533,551      | 547,113      |              |              |              |              |              |              |
| ,041   | 534,943      | 538,427      |              |              |              |              |              |              |              |
| ,569   | 539,427      |              |              |              |              |              |              |              |              |
| ,295   |              |              |              |              |              |              |              |              |              |
| ,124   | \$ 199,230   | \$ 254,679   | \$ 227,815   | \$ 239,639   | \$ 227,263   | \$ 182,502   | \$ 116,451   | \$ 105,567   | \$ 105,567   |
| 32,599 | \$ 1,331,866 | \$ 1,318,777 | \$ 1,192,178 | \$ 1,159,311 | \$ 1,146,460 | \$ 1,173,943 | \$ 1,150,714 | \$ 1,158,483 | \$ 1,158,483 |
| 4,180) | (593,209)    | (525,671)    | (417,250)    | (350,284)    | (336,392)    | (354,163)    | (353,805)    | (359,884)    | (359,884)    |
| ,419   | \$ 738,657   | \$ 793,106   | \$ 774,928   | \$ 809,027   | \$ 810,068   | \$ 819,780   | \$ 796,909   | \$ 798,599   | \$ 798,599   |
| ,755   | \$ 979,789   | \$ 879,739   | \$ 861,421   | \$ 874,171   | \$ 894,944   | \$ 948,089   | \$ 1,001,955 | \$ 1,038,976 | \$ 1,038,976 |
| 3,460) | (440,362)    | (341,312)    | (314,308)    | (304,783)    | (312,139)    | (310,811)    | (321,497)    | (345,944)    | (345,944)    |
| ,295   | \$ 539,427   | \$ 538,427   | \$ 547,113   | \$ 569,388   | \$ 582,805   | \$ 637,278   | \$ 680,458   | \$ 693,032   | \$ 693,032   |
| ,844   | \$ 352,077   | \$ 439,038   | \$ 330,757   | \$ 285,140   | \$ 251,516   | \$ 225,854   | \$ 148,759   | \$ 119,507   | \$ 119,507   |

## OPERATING RATIOS

## PREMIUMS TO SURPLUS RATIO

The following table shows, for the periods indicated, our insurance subsidiaries' statutory ratios of net premiums written to policyholders' surplus. While there is no statutory requirement applicable to us that establishes a permissible net premiums written to surplus ratio, guidelines established by the National Association of Insurance Commissioners (NAIC) provide that this ratio should generally be no greater than 3 to 1. While the NAIC provides this general guideline, rating agencies often require a more conservative ratio to maintain strong or superior ratings.

| (dollars in thousands)         | Year Ended December 31, |            |            |            |            |
|--------------------------------|-------------------------|------------|------------|------------|------------|
|                                | 2014                    | 2013       | 2012       | 2011       | 2010       |
| Statutory net premiums written | \$ 703,152              | \$ 666,322 | \$ 593,086 | \$ 549,638 | \$ 485,140 |
| Policyholders' surplus         | 849,297                 | 859,221    | 684,072    | 710,186    | 732,379    |
| Ratio                          | 0.8 to 1                | 0.8 to 1   | 0.9 to 1   | 0.8 to 1   | 0.7 to 1   |

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## GAAP AND STATUTORY COMBINED RATIOS

Our underwriting experience is best indicated by our GAAP combined ratio, which is the sum of (a) the ratio of incurred losses and settlement expenses to net premiums earned (loss ratio) and (b) the ratio of policy acquisition costs and other operating expenses to net premiums earned (expense ratio). The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss.

| GAAP           | Year Ended December 31, |      |      |      |      |
|----------------|-------------------------|------|------|------|------|
|                | 2014                    | 2013 | 2012 | 2011 | 2010 |
| Loss ratio     | 43.2                    | 41.2 | 47.1 | 37.2 | 40.8 |
| Expense ratio  | 41.3                    | 41.9 | 41.9 | 42.4 | 39.6 |
| Combined ratio | 84.5                    | 83.1 | 89.0 | 79.6 | 80.4 |

We also calculate the statutory combined ratio, which is not indicative of GAAP underwriting income due to accounting for policy acquisition costs differently for statutory accounting purposes compared to GAAP. The statutory combined ratio is the sum of (a) the ratio of statutory loss and settlement expenses incurred to statutory net premiums earned (loss ratio) and (b) the ratio of statutory policy acquisition costs and other underwriting expenses to statutory net premiums written (expense ratio). The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss.

| Statutory               | Year Ended December 31, |          |           |           |           |
|-------------------------|-------------------------|----------|-----------|-----------|-----------|
|                         | 2014                    | 2013     | 2012      | 2011      | 2010      |
| Loss ratio              | 43.2                    | 41.2     | 47.2      | 37.2      | 40.8      |
| Expense ratio           | 40.9                    | 41.0     | 40.8      | 41.9      | 40.6      |
| Combined ratio          | 84.1                    | 82.2     | 88.0      | 79.1      | 81.4      |
| Industry combined ratio | 96.0 (1)                | 95.8 (2) | 103.1 (2) | 108.2 (2) | 102.5 (2) |

(1) Source: Conning – Total Industry Forecast 2014Q4 – Commercial Lines. Estimated for the year ended December 31, 2014.

(2) Source: A.M. Best Aggregate & Averages — Property/Casualty, United States & Canada (2014 Edition) statutory basis.

## INVESTMENTS

Our investment portfolio serves as the primary resource for loss payments and secondly as a source of income to support operations. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on growing book value through total return. Investments of the highest quality and marketability are critical for preserving our claims-paying ability. Our portfolio contains no derivatives or off-balance sheet structured investments. In addition, we have a diversified investment portfolio which distributes credit risk across many issuers and a policy that limits aggregate credit exposure. Despite periodic fluctuations in market value, our equity portfolio is part of a long-term asset allocation strategy and has contributed significantly to our growth in book value.

Investment portfolios are managed both internally and externally by experienced portfolio managers. We follow an investment policy that is reviewed quarterly and revised periodically, with oversight conducted by our senior officers and board of directors.

Our investments include fixed income debt securities, common stock equity securities and exchange traded funds (ETFs). During 2014, the majority of available cash flows were invested in fixed income securities. Our equity allocation decreased to 21 percent of the overall portfolio. During the year, we initiated investments in a low income housing tax credit partnership and membership stock in the Federal Home Loan Bank of Chicago, which are included in other invested assets. At the end of the year, these two investments represented less than one percent of the total portfolio. As of December 31, 2014, 84 percent of the fixed income portfolio was rated A or better and 62 percent was rated AA or better.

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We classify all of the securities in our fixed income portfolio as available-for-sale, which are carried at fair value. The available-for-sale portfolio provides an additional source of liquidity and can be used to address potential future changes in our asset/liability structure. During the fourth quarter we sold our final remaining fixed income security that was classified as held-to-maturity.

Aggregate maturities for the fixed-income portfolio as of December 31, 2014, are as follows:

| (in thousands)                    | Par<br>Value | Amortized<br>Cost | Fair<br>Value | Carrying<br>Value |
|-----------------------------------|--------------|-------------------|---------------|-------------------|
| 2015                              | \$ 19,128    | \$ 19,147         | \$ 19,368     | \$ 19,368         |
| 2016                              | 25,355       | 25,931            | 26,245        | 26,245            |
| 2017                              | 40,949       | 41,832            | 43,231        | 43,231            |
| 2018                              | 38,633       | 39,207            | 42,410        | 42,410            |
| 2019                              | 109,144      | 112,597           | 117,260       | 117,260           |
| 2020                              | 105,272      | 110,192           | 113,426       | 113,426           |
| 2021                              | 185,669      | 193,719           | 199,649       | 199,649           |
| 2022                              | 96,067       | 99,611            | 103,060       | 103,060           |
| 2023                              | 79,359       | 83,711            | 86,481        | 86,481            |
| 2024                              | 78,063       | 82,963            | 85,191        | 85,191            |
| 2025                              | 57,810       | 63,897            | 65,970        | 65,970            |
| 2026                              | 50,270       | 53,929            | 56,086        | 56,086            |
| 2027                              | 55,110       | 62,668            | 65,715        | 65,715            |
| 2028                              | 30,770       | 34,764            | 36,196        | 36,196            |
| 2029                              | 25,870       | 28,956            | 30,054        | 30,054            |
| 2030 and later                    | 4,300        | 4,742             | 4,973         | 4,973             |
| Total excluding<br>Mtge/ABS/CMBS* | \$ 1,001,769 | \$ 1,057,866      | \$ 1,095,315  | \$ 1,095,315      |
| Mtge/ABS/CMBS*                    | \$ 381,158   | \$ 390,338        | \$ 399,772    | \$ 399,772        |
| Grand Total                       | \$ 1,382,927 | \$ 1,448,204      | \$ 1,495,087  | \$ 1,495,087      |

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

We had cash, short-term investments and fixed income securities maturing within one year of \$66.3 million at year-end 2014. This total represented 3 percent of cash and invested assets, down from 4 percent the prior year. Our short-term investments consist of investments with original maturities of 90 days or less, primarily AAA-rated prime and government money market funds.

## REGULATION



## STATE REGULATION

As an insurance holding company, we, as well as our insurance company subsidiaries, are subject to regulation by the states and territories in which the insurance subsidiaries are domiciled or transact business. Holding company registration in each insurer's state of domicile requires periodic reporting to the state regulatory authority of the financial, operational and management data of the insurers within the holding company system. All transactions within a holding company system affecting insurers must have fair and reasonable terms, and the insurer's policyholder surplus following any transaction must be both reasonable in relation to its outstanding liabilities and adequate for its needs. Notice to, and in some cases consent from, regulators are required prior to the consummation of certain transactions affecting insurance company subsidiaries of the holding company system. Each of the 50 states individually regulates the insurance operations of both insurance companies and insurance agents/brokers. Because our insurance companies operate in all 50 states, we must comply with the individual insurance laws, regulations, rules and case law of each state, including those regulating the filing of insurance rates and forms. Each of our four insurance company subsidiaries is domiciled in Illinois, with the Illinois Department of Insurance as their principal insurance regulator.

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The insurance holding company laws also require that ordinary dividends paid by an insurance company be reported to the insurer's domiciliary regulator prior to payment of the dividend and that extraordinary dividends may not be paid without such regulator's prior approval. An extraordinary dividend is generally defined under Illinois law as a dividend that, together with all other dividends made within the past 12 months, exceeds the greater of 100 percent of the insurer's statutory net income for the most recent calendar year or 10 percent of its statutory policyholders' surplus as of the preceding year end. Insurance regulators have broad powers to prevent the reduction of statutory surplus to inadequate levels, and there is no assurance that extraordinary dividend payments would be permitted.

Other regulations impose restrictions on the amount and type of investments our insurance company subsidiaries may have. Regulations designed to ensure financial solvency of insurers and require fair and adequate treatment and service for policyholders are enforced by various filing, reporting and examination requirements. Marketplace oversight is conducted by monitoring and periodically examining trade practices, approving policy forms, licensing of agents and brokers, and requiring the filing and, in some cases, approval of premiums and commission rates to ensure they are fair and equitable. Financial solvency is monitored by minimum reserve and capital requirements (including risk-based capital requirements), periodic financial reporting procedures (annually, quarterly or more frequently if necessary) and periodic examinations.

The quarterly and annual financial reports to the states utilize statutory accounting principles that are different from GAAP, which present the business as a going concern. The statutory accounting principles used by insurance regulators, in keeping with the intent to assure policyholder protection, are generally based on a solvency concept.

Many jurisdictions have laws and regulations that limit an insurer's ability to withdraw from a particular market. For example, states may limit an insurer's ability to cancel or non-renew policies. Furthermore, certain states prohibit an insurer from withdrawing one or more lines of business from the state, except pursuant to a plan that is approved by the state insurance department. The state insurance department may disapprove a withdrawal plan that may lead to marketplace disruption. Laws and regulations that limit cancellation and non-renewal and that subject program withdrawals to prior approval requirements may restrict our ability to exit unprofitable marketplaces in a timely manner.

In addition, state-level changes to the insurance regulatory environment are frequent, including changes caused by state legislation, regulations by the state insurance regulators and court rulings. State insurance regulators are members of the National Association of Insurance Commissioners (NAIC). The NAIC is a non-governmental regulatory support organization that seeks to promote uniformity and to enhance state regulation of insurance through various activities, initiatives and programs. Among other regulatory and insurance company support activities, the NAIC maintains a state insurance department accreditation program and proposes model laws, regulations and guidelines for approval by state legislatures and insurance regulators. Such proposed laws and regulations cover areas including risk assessments, corporate governance and financial and accounting rules. To the extent such proposed model laws and regulations are adopted by states, they will apply to insurance carriers.

Virtually all states require licensed insurers to participate in various forms of guaranty associations in order to bear a portion of the loss suffered by the policyholders of insurance companies that become insolvent. Depending upon state law, licensed insurers can be assessed an amount that is generally equal to a small percentage of the annual premiums written for the relevant lines of insurance in that state to pay the claims of an insolvent insurer. These assessments may increase or decrease in the future, depending upon the rate of insolvencies of insurance companies. In some states, these assessments may be wholly or partially recovered through policy fees paid by insureds.

In addition, the insurance holding company laws require advance approval by state insurance commissioners of any change in control of an insurance company that is domiciled (or, in some cases, having such substantial business that it is deemed to be commercially domiciled) in that state. "Control" is generally presumed to exist through the ownership of 10 percent or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. In addition, insurance laws in many states contain provisions that require pre-notification to the insurance commissioners of a change in control of a non-domestic insurance company licensed in those states. Any future transactions that would constitute a change in control of our insurance company subsidiaries, including a change of control of us, would generally require the party acquiring control to obtain the prior approval by the insurance departments of the insurance company subsidiaries' state of domicile (Illinois) or commercial domicile, if any, and may require pre-acquisition notification in applicable states that have adopted pre-acquisition notification provisions. Obtaining these approvals could result in a material delay of, or deter, any such transaction.

In addition to monitoring our existing regulatory obligations, we are also monitoring developments in the following areas to determine the potential effect on our business and to comply with our legal obligations.

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FEDERAL LEGISLATION / REGULATION

The U.S. insurance industry is not currently subject to any significant federal regulation and instead is regulated principally at the state level. However, the federal Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) and creation of the Federal Insurance Office (summarized below) include elements that affect the insurance industry, insurance companies and public companies such as ours.

The Sarbanes-Oxley Act established several significant corporate governance-related laws and Security and Exchange Commission (SEC) regulations applicable to public companies. The Dodd-Frank Act created significant changes in regulatory structures of banking and other financial institutions, created new governmental agencies (while merging and removing others), increased oversight of financial institutions and enhanced regulation of capital markets. The legislation also mandates new rules affecting executive compensation and corporate governance for public companies such as ours.

In addition, the Dodd-Frank Act contains insurance industry-specific provisions, including establishment of the Federal Insurance Office (FIO) and streamlining the regulation and taxation of surplus lines insurance and reinsurance among the states. The FIO, part of the U.S. Department of Treasury, has limited authority and no direct regulatory authority over the business of insurance. FIO's principal mandates include monitoring the insurance industry, collection of insurance industry information and data and representation of the U.S. with international insurance regulators. Although the FIO does not provide substantive regulation of the insurance industry at this time, we will monitor its activities carefully for any regulatory impact on our company. Many aspects of the Dodd-Frank Act affecting our company will be implemented over time by various federal agencies, including the SEC. Full implementation is expected to take several more years. We will continue to monitor, implement and comply with all Dodd-Frank Act-related changes to our regulatory environment, any FIO initiatives and any other federal legislation impacting our company.

As part of the passage of the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA), in January 2015, the National Association of Registered Agents and Brokers (NARAB) was established by federal law, which is expected to streamline insurance agent/broker licensing.

Other federal laws and regulations apply to many aspects of our company and its business operations. This federal regulation includes, without limitation, laws affecting privacy and data security and credit reporting — examples of which include the Gramm-Leach-Bliley Act, Fair Credit Reporting Act and Fair and Accurate Credit Transactions Act; and international economic and trade sanctions — examples of which include the Office of Foreign Asset Control (OFAC), Foreign Account Tax Compliance Act and the Iran Threat Reduction and Syrian Human Rights Act (ITR/SHR). ITR/SHR generally prohibits U.S. companies from engaging in certain transactions with the government of Iran or certain Iranian businesses, including provision of insurance or reinsurance. Under ITR/SHR, we must

disclose whether we or any of our affiliates knowingly engaged in certain specified activities identified in that law. For the year 2014, neither we nor our affiliates have knowingly engaged in any transaction or dealing reportable under Section 13(r) of the Exchange Act, as required by the ITR/SHR.

## LICENSES AND TRADEMARKS

We enter into various license arrangements with third parties and vendors on a regular basis for various goods and services. For example, we have license agreements with third parties for a variety of services, including natural catastrophe modeling, policy management, claims processing, producer management and accounting/financial management.

We hold a U.S. federal service mark registration of our corporate logo “RLI” and several other company service marks and trademarks with the U.S. Patent and Trademark Office. Such registrations protect our intellectual property nationwide from deceptively similar use. The duration of these registrations is 10 years, unless renewed. We monitor our trademarks and service marks and protect them from unauthorized use as necessary.

## EMPLOYEES

As of December 31, 2014, we employed a total of 882 associates. Of the 882 total associates, 33 were part-time and 849 were full-time.

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FORWARD LOOKING STATEMENTS

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 appear throughout this report. These statements relate to our current expectations, beliefs, intentions, goals or strategies regarding the future and are based on certain underlying assumptions by us. These forward looking statements generally include words such as “expect,” “predict,” “estimate,” “will,” “should,” “anticipate,” “believe” and similar expressions. Such assumptions are, in turn, based on information available and internal estimates and analyses of general economic conditions, competitive factors, conditions specific to the property and casualty insurance and reinsurance industries, claims development and the impact thereof on our loss reserves, the adequacy and financial security of our reinsurance programs, developments in the securities market and the impact on our investment portfolio, regulatory changes and conditions and other factors and are subject to various risks, uncertainties and other factors, including, without limitation those set forth below in “Item 1A Risk Factors.” Actual results could differ materially from those expressed in, or implied by, these forward looking statements. We assume no obligation to update any such statements. You should review the various risks, uncertainties and other factors listed from time to time in our Securities and Exchange Commission filings.

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Item 1A. Risk Factors

Our results of operations and revenues may fluctuate as a result of many factors, including cyclical changes in the insurance industry, which may cause the price of our securities to be volatile.

The results of operations of companies in the property and casualty insurance industry historically have been subject to significant fluctuations and uncertainties. Our profitability can be affected significantly by:

- Competitive pressures impacting our ability to retain business at an adequate rate,
- Rising levels of loss costs that we cannot anticipate at the time we price our coverages,
- Volatile and unpredictable developments, including man-made, weather-related and other natural CATs, terrorist attacks or significant price changes of the commodities we insure,
- Changes in the level of private and government-related reinsurance capacity and
- Changes in the amount of losses resulting from new types of claims and new or changing judicial interpretations relating to the scope of insurers' liabilities.

In addition, the demand for property and casualty insurance, both admitted and excess and surplus lines, can vary significantly, rising as the overall level of economic activity increases and falling as that activity decreases, causing our revenues to fluctuate. These fluctuations in results of operations and revenues may cause the price of our securities to be volatile.

Adverse changes in the economy could lower the demand for our insurance products and could have an adverse effect on the revenue and profitability of our operations.

Factors such as business revenue, construction spending, government spending, the volatility and strength of the capital markets and inflation can all affect the business and economic environment. These same factors affect our ability to generate revenue and profits. Insurance premiums in our markets are heavily dependent on our customer revenues, values transported, miles traveled and number of new projects initiated. In an economic downturn that is characterized by higher unemployment, declines in construction spending and reduced corporate revenues, the demand for insurance products is adversely affected. Adverse changes in the economy may lead our customers to have less need for insurance coverage, to cancel existing insurance policies, to modify coverage or to not renew with us, all of which affect our ability to generate revenue.

Catastrophic losses, including those caused by natural disasters, such as earthquakes and hurricanes, or man-made events such as terrorist attacks, are inherently unpredictable and could cause us to suffer material financial losses.

We face the risk of property damage resulting from catastrophic events, particularly earthquakes on the West Coast and hurricanes and tropical storms affecting the continental U.S. or Hawaii. Since the Northridge, California earthquake in 1994, most of our CAT-related claims have resulted from hurricanes and other seasonal storms such as tornadoes and hail storms.

The incidence and severity of CATs are inherently unpredictable. The extent of losses from a CAT is a function of both the total amount of insured values in the area affected by the event and the severity of the event. Most CATs are restricted to fairly specific geographic areas. However, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. In addition to hurricanes and earthquakes, CAT losses can be due to windstorms, severe winter weather and fires and may include terrorist events. In addition, climate change could have an impact on longer-term natural CAT trends. Extreme weather events that are linked to rising temperatures, changing global weather patterns, sea, land and air temperatures, as well as sea levels, rain and snow could result in increased occurrence and severity of CATs. CATs can cause losses in a variety of our property and casualty segments, and it is possible that a catastrophic event or multiple catastrophic events could cause us to suffer material financial losses. In addition, CAT claims costs may be higher than we originally estimate and could cause substantial volatility in our financial results for any fiscal quarter or year. Our ability to write new business could also be affected. We believe that increases in the value and geographic concentration of insured property, the effects of inflation and the growth of our workers compensation business could also increase the severity of claims from CAT events in the future.

Actual insured losses may be greater than our loss reserves, which would negatively impact our profitability.

Significant periods of time often elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities representing



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estimates of amounts needed to pay reported and unreported losses and the related loss adjustment expenses. Loss reserves are just an estimate of the ultimate costs of claims and do not represent an exact calculation of liability. Estimating loss reserves is a difficult and complex process involving many variables and subjective judgments. As part of the reserving process, we review historical data and consider the impact of various factors such as:

- Loss emergence and cedant reporting patterns,
- Underlying policy terms and conditions,
- Business and exposure mix,
- Trends in claim frequency and severity,
- Changes in operations,
- Emerging economic and social trends,
- Inflation and
- Changes in the regulatory and litigation environments.

This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. It also assumes that adequate historical or other data exists upon which to make these judgments. There is no precise method, however, for evaluating the impact of any specific factor on the adequacy of reserves and actual results are likely to differ from original estimates. If the actual amount of insured losses is greater than the amount we have reserved for these losses, our profitability could suffer.

We may suffer losses from litigation, which could materially and adversely affect our financial condition and business operations.

As is typical in our industry, we continually face risks associated with litigation of various types, including disputes relating to insurance claims under our policies as well as other general commercial and corporate litigation. We are party to a variety of litigation matters throughout the year. Litigation is subject to inherent uncertainties, and if there were an outcome unfavorable to us, there exists the possibility of a material adverse impact on our results of operations and financial position in the period in which the outcome occurs. And even if an unfavorable outcome does not materialize, we still may face substantial expense and disruption associated with the litigation.

Our reinsurers may not pay on losses in a timely fashion, or at all, which may increase our costs.

We purchase reinsurance by transferring part of the risk we have assumed (known as ceding) to a reinsurance company in exchange for part of the premium we receive in connection with the risk. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us (the reinsured) of our liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. That is, our reinsurers may not pay claims made by us on a timely basis, or they may not pay some or all of these claims for a variety of reasons. Either of these events would increase our costs and could have a materially adverse effect on our

business.

If we cannot obtain adequate reinsurance protection for the risks we have underwritten, we may be exposed to greater losses from these risks or we may reduce the amount of business we underwrite, which will reduce our revenues.

Market conditions beyond our control determine the availability and cost of the reinsurance protection that we purchase. In addition, the historical results of reinsurance programs and the availability of capital also affect the availability of reinsurance. Our reinsurance facilities are generally subject to annual renewal. We cannot be sure that we can maintain our current reinsurance facilities or that we can obtain other reinsurance facilities in adequate amounts and at favorable rates. If we are unable to renew our expiring facilities or to obtain new reinsurance facilities on terms we deem acceptable, either our net exposures would increase—which could increase the volatility of our results—or, if we were unwilling to bear an increase in net exposures, we would have to reduce the level of our underwriting commitments—especially CAT-exposed risks—which would reduce our revenues.

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Our investment results and, therefore, our financial condition may be impacted by changes in the business, financial condition or operating results of the entities in which we invest, as well as changes in interest rates, government monetary policies, general economic conditions, liquidity and overall market conditions.

We invest the premiums we receive from customers until they are needed to pay expenses or policyholder claims. Funds remaining after paying expenses and claims remain invested and are included in retained earnings. The value of our investment portfolio can fluctuate as a result of changes in the business, financial condition or operating results of the entities in which we invest. In addition, fluctuations can result from changes in interest rates, including a change in company-specific risk premium above a risk free rate, government monetary policies, liquidity of holdings and general economic conditions. These fluctuations may, in turn, negatively impact our financial condition and impair our ability to raise capital, if needed.

We compete with a large number of companies in the insurance industry for underwriting revenues.

We compete with a large number of other companies in our selected lines of business. During periods of intense competition for premium (soft markets), we are vulnerable to the actions of other companies who may seek to write business without the appropriate regard for ultimate profitability. During these times, it is very difficult to grow or maintain premium volume without sacrificing underwriting discipline and income.

We face competition both from specialty insurance companies, underwriting agencies and intermediaries, as well as diversified financial services companies that are significantly larger than we are and that have significantly greater financial, marketing, management and other resources. We may also face competition from new sources of capital such as institutional investors seeking access to the insurance market, sometimes referred to as alternative capital, which may depress pricing or limit our opportunities to write business. Some of these competitors also have greater experience and market recognition than we do. We may incur increased costs in competing for underwriting revenues. If we are unable to compete effectively in the markets in which we operate or expand our operations into new markets, our underwriting revenues may decline, as well as overall business results.

A number of new, proposed or potential legislative or industry developments could further increase competition in our industry. These developments include:

- An increase in capital-raising by companies in our lines of business, which could result in new entrants to our markets and an excess of capital in the industry,
- The deregulation of commercial insurance lines in certain states and the possibility of federal regulatory reform of the insurance industry, which could increase competition from standard carriers for our excess and surplus lines of insurance business,
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Programs in which state-sponsored entities provide property insurance in CAT-prone areas or other “alternative markets” types of coverage and

- Changing practices caused by the Internet, which may lead to greater competition in the insurance business.

New competition from these developments could cause the supply and/or demand for insurance or reinsurance to change, which could affect our ability to price our coverages at attractive rates and thereby adversely affect our underwriting results.

A downgrade in our ratings from A.M. Best, Standard & Poor’s, or Moody’s could negatively affect our business.

Financial strength ratings are a critical factor in establishing the competitive position of insurance companies. Our insurance companies are rated for overall financial strength by A.M. Best, Standard & Poor’s and Moody’s. A.M. Best, Standard & Poor’s and Moody’s ratings reflect their opinions of an insurance company’s and an insurance holding company’s financial strength, operating performance, strategic position and ability to meet its obligations to policyholders, and are not evaluations directed to investors. Our ratings are subject to periodic review by such firms, and we cannot assure the continued maintenance of our current ratings. All of our ratings were reviewed during 2014. A.M. Best reaffirmed its “A+, Superior” rating for the combined entity of RLI Ins., Mt. Hawley, RIC and CBIC (group-rated). Standard & Poor’s reaffirmed our “A+, Strong” rating for the group of RLI Ins. and Mt. Hawley. Moody’s reaffirmed our group rating of “A2, Good” for RLI Ins., Mt. Hawley and RIC. Because these ratings have become an increasingly important factor in establishing the competitive position of insurance companies, if our ratings are reduced from their current levels by A.M. Best, Standard & Poor’s or Moody’s, our competitive position in the industry, and therefore our business, could be adversely affected. A significant downgrade could

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result in a substantial loss of business, as policyholders might move to other companies with higher claims-paying and financial strength ratings.

We are subject to extensive governmental regulation, which may adversely affect our ability to achieve our business objectives. Moreover, if we fail to comply with these regulations, we may be subject to penalties, including fines and suspensions, which may adversely affect our financial condition and results of operations.

As an insurance company, we are subject to extensive governmental regulation and supervision. Most insurance regulations are designed to protect the interests of policyholders rather than shareholders and other investors. These regulations, generally administered by a department of insurance in each state in which we do business, relate to, among other things:

- Approval of policy forms and premium rates,
- Standards of solvency, including risk-based capital measurements,
- Licensing of insurers and their producers,
- Restrictions on agreements with our large revenue-producing agents,
- Cancellation and non-renewal of policies,
- Restrictions on the nature, quality and concentration of investments,
  - Restrictions on the ability of our insurance company subsidiaries to pay dividends to us,
- Restrictions on transactions between insurance company subsidiaries and their affiliates,
- Restrictions on the size of risks insurable under a single policy,
- Requiring deposits for the benefit of policyholders,
- Requiring certain methods of accounting,
- Periodic examinations of our operations and finances,
- Prescribing the form and content of records of financial condition required to be filed and
- Requiring reserves for unearned premium, losses and other purposes.

State insurance departments also conduct periodic examinations of the conduct and affairs of insurance companies and require the filing of annual, quarterly and other reports relating to financial condition, holding company issues and other matters. These regulatory requirements may adversely affect or inhibit our ability to achieve some or all of our business objectives.

In addition, regulatory authorities have relatively broad discretion to deny or revoke licenses for various reasons, including the violation of regulations. In some instances, we follow practices based on our interpretations of regulations or practices that we believe may be generally followed by the industry. These practices may turn out to be different from the interpretations of regulatory authorities. If we do not have the requisite licenses and approvals or do not comply with applicable regulatory requirements, insurance regulatory authorities could fine us, preclude or temporarily suspend us from carrying on some or all of our activities or otherwise penalize us. This could adversely affect our ability to operate our business. Further, changes in the level of regulation of the insurance industry or

changes in laws or regulations themselves or interpretations by regulatory authorities could adversely affect our ability to operate our business as currently conducted.

In addition to regulations specific to the insurance industry, including the insurance laws of our principal state regulator (Illinois), as a public company we are also subject to the rules and regulations of the U.S. Securities and Exchange Commission and the New York Stock Exchange, each of which regulate many areas such as financial and business disclosures, corporate governance and shareholder matters. We are also subject to the corporation laws of Illinois, where we and our four insurance company subsidiaries are incorporated. At the federal level, among other laws, we are subject to the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act, each of which regulate corporate governance, executive compensation and other areas, as well as laws relating to federal trade restrictions, privacy/data security, crop insurance and terrorism risk insurance laws. We monitor these laws, regulations and rules on an ongoing basis to ensure compliance and make appropriate changes as

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necessary. Implementing such changes may require adjustments to our business methods, increases to our costs and other changes that could cause us to be less competitive in our industry.

We may be unable to attract and retain qualified key employees.

We depend on our ability to attract and retain qualified executive officers, experienced underwriting talent and other skilled employees who are knowledgeable about our business. Providing suitable succession planning for such positions is also important. If we cannot attract or retain top-performing executive officers, underwriters and other employees, if the quality of their performance decreases, or if we fail to implement succession plans for our key staff, we may be unable to maintain our current competitive position in the markets in which we operate and be unable to expand our operations into new markets.

We are an insurance holding company and, therefore, may not be able to receive adequate or timely dividends from our insurance subsidiaries.

RLI Corp. is the holding company for our four insurance operating companies. At the holding company level, our principal assets are the shares of capital stock of our insurance company subsidiaries. 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. 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. Ordinary dividends, which may be paid by our principal insurance subsidiary without prior regulatory approval, are subject to certain limitations based upon 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. Because the limitations are based upon a rolling 12-month period, the presence, amount and impact of these restrictions vary over time.

Anti-takeover provisions affecting us could prevent or delay a change of control that is beneficial to you.

Provisions of our articles of incorporation and by-laws, as well as applicable Illinois law, federal and state regulations and insurance company regulations may discourage, delay or prevent a merger, tender offer or other change of control that holders of our securities may consider favorable. Some of these provisions impose various procedural and other requirements that could make it more difficult for shareholders to effect certain corporate actions. These provisions

could:

- Have the effect of delaying, deferring or preventing a change in control of us,
- Discourage bids for our securities at a premium over the market price,
- Adversely affect the market price of, and the voting and other rights of the holders of, our securities or
  - Impede the ability of the holders of our securities to change our management.

Breaches or interruptions of our computer systems could adversely affect our financial condition and results of operations.

We rely on multiple computer systems to issue policies, pay claims, run modeling functions, assess insurance risks and complete various important internal processes including accounting and bookkeeping. Our business is highly dependent on our ability to access these systems to perform necessary business functions. Additionally, some of these systems may include or rely upon third-party systems not located on RLI premises. Any of these systems may be exposed to unplanned interruption, unreliability, intrusion and data breaches.

Any such issues could materially impact our company including the impairment of information availability, compromise of system integrity/accuracy, misappropriation of confidential information, reduction of our volume of transactions and interruption of our general business. Although we believe our computer systems are securely protected and continue to take steps to ensure they are protected against cyber-security risks, we cannot guarantee that such problems will never occur. If they do, interruption to our business and damage to our reputation, and related costs, could be significant, which could impair our profitability.

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We may not be able to effectively start up or integrate a new product opportunity.

Our ability to grow our business depends, in part, on our creation, implementation and acquisition of new insurance products that are profitable and fit within our business model. New product launches as well as business acquisitions are subject to many obstacles, including ensuring we have sufficient business and systems processes, determining appropriate pricing, assessing opportunity costs and regulatory burdens and planning for internal infrastructure needs. If we cannot accurately assess and overcome these obstacles or we improperly implement new insurance products, our ability to grow profitably will be impaired.

Access to capital and market liquidity may adversely affect our ability to take advantage of business opportunities as they arise.

Our ability to grow our business depends in part on our ability to access capital when needed. We cannot predict capital market liquidity or the availability of capital. We also cannot predict the extent and duration of future economic and market disruptions, the impact of government interventions into the market to address these disruptions and their combined impact on our industry, business and investment portfolios. If our company needs capital but cannot raise it, our business and future growth could be adversely affected.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We own five commercial buildings on our 23 acre corporate campus in Peoria, Illinois. Our primary building is a two-story 77,000 square foot office building, which serves as our corporate headquarters. Located on the same campus is a 24,000 square foot building, which is used by two branch offices of RLI Ins., and a 15,000 square foot office building. In addition, we own a 26,000 square foot multi-story building used for record storage and a 12,000 square foot building used for furniture and equipment storage.

Most of our branch offices and other company operations lease office space throughout the country. Management considers our office facilities suitable and adequate for our current levels of operations.

### Item 3. Legal Proceedings

We are party to numerous claims, losses and litigation matters that arise in the normal course of our business. Many of such claims, losses or litigation matters involve claims under policies that we underwrite as an insurer. We believe that the resolution of these claims and losses will not have a material adverse effect on our financial condition, results of operations or cash flows.

We are also involved in various other legal proceedings and litigation unrelated to our insurance business from time to time that arise in the ordinary course of business operations. Management believes that any liabilities that may arise as a result of these legal matters will not have a material adverse effect on our financial condition, results of operations or cash flows.

As previously reported in our 10-Q Quarterly Report for the quarter ended September 30, 2014, in July 2014 the Belmont Massachusetts Contributory Retirement System filed a putative shareholder class action and derivative lawsuit against RLI Corp. and its Board of Directors in Illinois state court. In December 2014 we reached a settlement on terms we believe are favorable and in the best interests of the company and its shareholders. The proposed settlement, which is subject to final court approval, included submitting proposed amendments of our equity incentive plans to a shareholder vote at our upcoming 2015 annual shareholder meeting, and payment to plaintiff's counsel of legal fees in an amount to be awarded by the court but not to exceed \$350,000. In February 2015, prior to the court hearing for final approval of the settlement, an objection to the settlement was filed. The court proceedings in this matter are ongoing. While it is not possible to predict the ultimate disposition of this matter and whether it will be resolved consistent with the proposed settlement, we believe the outcome will not have a material adverse effect on our financial condition, results of operations or cash flows.

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## Item 4. Mine Safety Disclosures

Not applicable.

## PART II

## Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

## (a) Investor Information:

## TRADING AND DIVIDEND INFORMATION

| 2014        | Closing Stock Price |          |          | Dividends |
|-------------|---------------------|----------|----------|-----------|
|             | High                | Low      | Ending   | Declared  |
| 1st Quarter | \$ 47.76            | \$ 40.31 | \$ 44.24 | \$ 0.17   |
| 2nd Quarter | 46.17               | 42.20    | 45.78    | 0.18      |
| 3rd Quarter | 46.53               | 42.74    | 43.29    | 0.18      |
| 4th Quarter | 50.54               | 42.98    | 49.40    | 3.18      |

| 2013        | Closing Stock Price |          |          | Dividends |
|-------------|---------------------|----------|----------|-----------|
|             | High                | Low      | Ending   | Declared  |
| 1st Quarter | \$ 36.11            | \$ 32.44 | \$ 35.93 | \$ 0.16   |
| 2nd Quarter | 38.21               | 34.96    | 38.21    | 0.17      |
| 3rd Quarter | 43.71               | 38.77    | 43.71    | 0.17      |
| 4th Quarter | 51.77               | 42.37    | 48.69    | 1.67      |

RLI common stock trades on the New York Stock Exchange under the symbol RLI. RLI has paid dividends for 154 consecutive quarters and increased dividends in each of the last 39 years. In December 2014 and 2013, RLI paid special cash dividends of \$3.00 and \$1.50 per share, respectively, to shareholders as of the record date. As of February 11, 2015, there were 829 registered holders of the Company's common stock.



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The following graph provides a five-year comparison of RLI's total return to shareholders compared to that of the S&P 500 and S&P P&C Index.

|                   |       | 2009   | 2010 | 2011 | 2012 | 2013 | 2014 |
|-------------------|-------|--------|------|------|------|------|------|
| RLI               | ----- | \$ 100 | 114  | 173  | 168  | 265  | 291  |
| S&P 500           | ..... | \$ 100 | 115  | 117  | 136  | 180  | 205  |
| S&P 500 P&C Index | — — — | \$ 100 | 109  | 109  | 130  | 180  | 209  |

Assumes \$100 invested on December 31, 2009, in RLI, S&P 500 and S&P 500 P&C Index, with reinvestment of dividends. Comparison of five-year annualized total return — RLI: 23.8%, S&P 500: 15.4%, and S&P 500 P&C Index: 15.9%.

Refer to Part III, Item 12, “Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters,” of this document for information on securities authorized for issuance under our equity compensation plan.

(b) Not applicable.

(c) Our common stock repurchase program, which authorized us to repurchase up to \$100 million of our Company's common stock, was initially approved by our board of directors on May 3, 2007. On November 14, 2007, our board of directors increased the previously announced repurchase program by \$100 million, for a total of \$200 million of our common stock. In the second quarter of 2010, we completed our \$200 million share repurchase program. On May 6, 2010, our Board of Directors implemented a new \$100 million share repurchase program. We did not repurchase any shares during 2014. We have \$87.5 million of remaining capacity from the repurchase program. The repurchase program may be suspended or discontinued at any time without prior notice.

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## Item 6. Selected Financial Data

The following is selected financial data of RLI Corp. and Subsidiaries for the 5 years ended December 31, 2014.

| (amounts in thousands, except per share data and ratios) | 2014         | 2013      | 2012        | 2011        | 2010        |
|--|--------------|-----------|-------------|-------------|-------------|
| <b>OPERATING RESULTS</b>                                 |              |           |             |             |             |
| Gross premiums written                                   | \$ 863,848   | 843,195   | 784,799     | 702,107     | 636,316     |
| Consolidated revenue                                     | \$ 775,165   | 705,601   | 660,774     | 619,169     | 583,424     |
| Net earnings   | \$ 135,445   | 126,255   | 103,346     | 126,598     | 128,197     |
| Comprehensive earnings(1)                                | \$ 170,801   | 119,112   | 129,191     | 147,931     | 146,778     |
| Net cash provided from operating activities              | \$ 123,085   | 134,966   | 36,240      | (8) 117,991 | (8) 100,235 |
| <b>FINANCIAL CONDITION</b>                               |              |           |             |             |             |
| Total investments and cash                               | \$ 1,964,285 | 1,922,058 | 1,840,881   | 1,900,288   | 1,803,021   |
| Total assets   | \$ 2,775,542 | 2,740,310 | 2,644,632   | 2,654,834   | 2,480,399   |
| Unpaid losses and settlement expenses                    | \$ 1,121,040 | 1,129,433 | 1,158,483   | 1,150,714   | 1,173,943   |
| Total debt   | \$ 149,625   | 149,582   | (7) 100,000 | 100,000     | 100,000     |
| Total shareholders' equity                               | \$ 845,062   | 828,966   | 796,363     | 792,634     | 769,151     |
| Statutory surplus(2)                                     | \$ 849,297   | 859,221   | 684,072     | 710,186     | 732,379     |
| <b>SHARE INFORMATION(3)</b>                              |              |           |             |             |             |
| Net earnings per share:                                  |              |           |             |             |             |
| Basic  | \$ 3.15      | 2.95      | 2.44        | 3.00        | 3.05        |
| Diluted  | \$ 3.09      | 2.90      | 2.39        | 2.95        | 3.02        |
| Comprehensive earnings per share:(1)                     |              |           |             |             |             |
| Basic  | \$ 3.97      | 2.79      | 3.04        | 3.51        | 3.49        |
| Diluted  | \$ 3.90      | 2.74      | 2.99        | 3.45        | 3.46        |
| Cash dividends declared per share:                       |              |           |             |             |             |
| Ordinary   | \$ 0.71      | 0.67      | 0.63        | 0.60        | 0.58        |
| Special(4)   | \$ 3.00      | 1.50      | 2.50        | 2.50        | 3.50        |
| Book value per share(4)                                  | \$ 19.61     | 19.29     | 18.73       | 18.73       | 18.34       |
| Closing stock price(4)                                   | \$ 49.40     | 48.69     | 32.33       | 36.43       | 26.29       |
| Stock Split  |              | 200       | % (3)       |             |             |
| Weighted average shares outstanding:                     |              |           |             |             |             |
| Basic  | 43,020       | 42,744    | 42,431      | 42,156      | 42,040      |
| Diluted  | 43,819       | 43,514    | 43,160      | 42,869      | 42,482      |
| Common shares outstanding                                | 43,103       | 42,982    | 42,525      | 42,324      | 41,929      |

## OTHER NON-GAAP FINANCIAL INFORMATION(5)(6)

|  |      |   |      |   |      |   |      |     |      |   |
|--|------|---|------|---|------|---|------|-----|------|---|
| Net premiums written to statutory surplus(2) | 83   | % | 78   | % | 87   | % | 77   | %   | 66   | % |
| GAAP combined ratio(6)                       | 84.5 |   | 83.1 |   | 89.0 |   | 79.6 |     | 80.4 |   |
| Statutory combined ratio(2)(6)               | 84.1 |   | 82.2 |   | 88.0 |   | 79.1 | (9) | 81.4 |   |

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- (1) See note 1.P to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.
- (2) Ratios and surplus information are presented on a statutory basis. As discussed in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, statutory accounting principles differ from GAAP and are generally based on a solvency concept. Further discussion is included in note 9 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data. Reporting of statutory surplus is a required disclosure under GAAP.
- (3) On January 15, 2014, our stock split on a 2-for-1 basis. All share and per share data has been retroactively stated to reflect this split.
- (4) In 2014, RLI Corp. declared and paid a special cash dividend of \$3.00 per share, which totaled \$129.3 million. Special dividends were also declared and paid in each of the previous four years, totaling \$64.5 million, \$106.3 million, \$105.8

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million and \$146.7 million for 2013, 2012, 2011 and 2010, respectively. The special dividends produced corresponding decreases to book value per share and our stock price.

- (5) See page 37 for information regarding non-GAAP financial measures.
- (6) The GAAP and statutory combined ratios are impacted by favorable development on prior accident years' loss reserves. For further discussion, see note 6 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.
- (7) On October 2, 2013, we successfully completed a public debt offering, issuing \$150.0 million in senior notes maturing September 15, 2023. This offering generated proceeds, net of discount and commission, of \$148.6 million. In December 2013, we redeemed \$100.0 million in senior notes that were issued in 2003 and were set to mature in January 2014.
- (8) Operating cash flow for 2011 includes a \$50.0 million cash deposit that we received from a commercial surety customer in lieu of credit. The return of this \$50.0 million deposit is reflected in operating cash flow for 2012.
- (9) Includes statutory results of CBIC post-acquisition.



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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

RLI Corp. underwrites selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group. As a specialty insurance company with a niche focus, we offer insurance coverages in both the specialty admitted and excess and surplus markets. Coverages in the specialty admitted market, such as our 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 admitted market, is less regulated and more flexible in terms of policy forms and premium rates. This market provides an alternative for customers with risks or loss exposures that generally cannot be written in the standard market. This typically results in coverages that are more restrictive and more expensive than coverages in the admitted market. When we underwrite within the excess and surplus market, we are selective in the lines of business and type of risks we choose to write. Using our non-admitted status in this market allows us to tailor terms and conditions to manage these exposures effectively. Often, the development of these coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients or loss exposures. Once a proposal is submitted, our underwriters determine whether it would be a viable product based on our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all market conditions and we achieved this for the 19th consecutive year in 2014, 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, a specialty E&S 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 profitability is analyzed through combined ratios, which are further subdivided into their respective loss

and expense components.

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

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aggregate exposure to a catastrophic event by minimizing the total policy limits written in a particular region, purchasing reinsurance and maintaining policy terms and conditions throughout market cycles. We also use computer-assisted modeling techniques to provide estimates that help us carefully manage the concentration of risks exposed to catastrophic events. Our assumed multi-peril crop and hail treaty reinsurance business covers revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects and disease. Significant aggregation of these losses is mitigated by the U.S. Federal Government reinsurance program that provides stop loss protection inuring to our benefit.

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

While rates generally improved over the past few years, many coverages experienced flat or declining prices during 2014. Excess capital in the market impacted the rate environment, and 2014 represented the second consecutive year without a natural catastrophe significant to the industry. As a result, the insurance marketplace remains very competitive. Despite these challenges, we believe that our business model is geared 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.

**BUSINESS DEVELOPMENT**

On February 5, 2014, we invested \$5.3 million for a 20 percent equity ownership interest in Prime, an Illinois domiciled insurance carrier based in Salt Lake City, Utah. Prime is a privately-held excess and surplus lines insurance company that distributes its products through a network of wholesale brokers and specializes in hard-to-place risks.

On November 2, 2012, we acquired Rockbridge, a Houston-based managing general agency, for \$15.5 million in cash, coupled with a contingent earn-out based on future underwriting profitability. Rockbridge specializes in medical professional liability insurance in the excess and surplus market. Coverage is offered to individual physicians and physician groups in all 50 states through a network of retail and wholesale brokers.

A more detailed discussion of the impact of these acquisitions is provided in the results of operations and segment highlights, as well as in note 13 to the consolidated financial statements within Item 8, Financial Statements and

Supplementary Data.

## GAAP AND NON-GAAP FINANCIAL PERFORMANCE METRICS

Throughout this annual 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 generally accepted accounting principles in the United States of America (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 non-GAAP 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 within Item 8, Financial Statements and Supplementary Data. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains/losses on investments, general corporate expenses, debt costs and unconsolidated investee earnings.

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### 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 consolidated financial statements. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss. For example, a combined ratio of 85 implies that for every \$100 of premium we earn, we record \$15 of underwriting income.

### Net Unpaid Loss and Settlement Expenses

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

## CRITICAL ACCOUNTING POLICIES

In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the 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 other-than-temporary impairment (OTTI), recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes.

## LOSSES AND SETTLEMENT EXPENSES

## Overview

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

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

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

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

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

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

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

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

LAE represents the cost involved in adjusting and administering losses from policies we issued. The LAE reserves are frequently separated into two components: allocated and unallocated. Allocated loss adjustment expense (ALAE) reserves represent an estimate of claims settlement expenses that can be identified with a specific claim or case. Examples of ALAE would be the hiring of an outside adjuster to investigate a claim or an outside attorney to defend

our insured. The claim professional typically estimates this cost separately from the loss component in the case reserve. Unallocated loss adjustment expense (ULAE) reserves represent an estimate of claims settlement expenses that cannot be identified with a specific claim. An example of ULAE would be the cost of an internal claim examiner to manage or investigate a reported claim.

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

#### Initial IBNR Generation Process

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

For most property products, we use an alternative method of determining an appropriate provision for initial IBNR. Since this segment is characterized by a shorter period of time between claim occurrence and claim settlement, the IBNR reserves are



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

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

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

The initial loss and ALAE ratios that are applied to earned premium are reviewed at least semi-annually. Prospective estimates are made based on historical loss experience adjusted for exposure mix, price change and loss cost trends. The initial loss and ALAE ratios also reflect our judgment as to estimation risk. We consider estimation risk by product and coverage within product, if applicable. A product with greater overall volatility and uncertainty has greater estimation risk. Products or coverages with higher estimation risk include, but are not limited to, the following characteristics:

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

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

## Loss and LAE Reserve Estimation Process

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

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

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industry average data as available and when appropriate. For our newer products such as crop reinsurance, as well as for executive products, professional services and marine, we utilize external data extensively.

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

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

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

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

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

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

- Economic environment.

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

A considerable degree of judgment in the evaluation of all these factors is involved in the analysis of reserves. The human element in the application of judgment is unavoidable when faced with uncertainty. Different experts will choose different assumptions based on their individual backgrounds, professional experiences and areas of focus. Hence, the estimates selected by various qualified experts may differ significantly from each other. We consider this uncertainty by examining our historic reserve accuracy and through an internal peer review process.

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

#### Determination of Our Best Estimate

Upon completion of our full loss and LAE estimation analysis, the results are discussed with the LRC. As part of this discussion, the analysis supporting the actuarial central estimate of the IBNR reserve by product is reviewed. The actuaries also

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

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

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

Actuarial methods attempt to quantify future outcomes. However, insurance companies are subject to unique exposures that are difficult to foresee at the point coverage is initiated and, often, many years subsequent. Judicial and regulatory bodies involved in interpretation of insurance contracts have increasingly found opportunities to expand coverage beyond that which was intended or contemplated at the time the policy was issued. Many of these policies are issued on an "all risk" and occurrence basis. Aggressive plaintiff attorneys have often sought coverage beyond the insurer's original intent. Some examples would be the industry's ongoing asbestos and environmental litigation, court interpretations of exclusionary language for mold and construction defect and debates over wind versus flood as the cause of loss from major hurricane events.

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

Our best estimate of loss and LAE reserves may change as a result of a revision in the actuarial central estimate, the actuary's certainty in the estimates and processes and our overall view of the underlying risks. From time to time, we benchmark our reserving policies and procedures and refine them by adopting industry best practices where

appropriate. A detailed, ground-up analysis of the actuarial estimation risks associated with each of our products and segments, including an assessment of industry information, is performed annually. This information is used when determining management's best estimate of booked reserves.

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

## INVESTMENT VALUATION AND OTTI

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

We classify our investments in debt and equity securities into one of three categories. Available-for-sale securities are carried at fair value with unrealized gains/losses recorded as a component of comprehensive earnings and shareholders' equity, net of deferred income taxes. During 2014, we sold our remaining debt securities classified as held-to-maturity. During 2013, we sold our remaining debt securities classified as trading.

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

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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 pricing categories that are used to classify fair value.

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

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

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

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

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

- A downgrade in credit quality by a major rating agency.

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

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



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

## RECOVERABILITY OF REINSURANCE BALANCES

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

## DEFERRED POLICY ACQUISITION COSTS

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

## DEFERRED TAXES

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

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

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

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Additional discussion of other significant accounting policies may be found in note 1 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

## RESULTS OF OPERATIONS

Consolidated revenue, as displayed in the table that follows, totaled \$775.2 million for 2014, compared to \$705.6 million for 2013 and \$660.8 million in 2012.

| CONSOLIDATED REVENUE<br>(in thousands) | Year ended December 31, |            |            |
|--|-------------------------|------------|------------|
|  | 2014                    | 2013       | 2012       |
| Net premiums earned                    | \$ 687,375              | \$ 630,802 | \$ 576,571 |
| Net investment income                  | 55,608                  | 52,763     | 58,831     |
| Net realized investment gains          | 32,182                  | 22,036     | 25,372     |
| Total consolidated revenue             | \$ 775,165              | \$ 705,601 | \$ 660,774 |

Consolidated revenue increased 10 percent in 2014, following 7 percent increases in 2013 and 2012. Premiums earned from insurance operations improved for each of the past three years, while investment income also increased during 2014, reversing a trend of moderate declines seen in recent periods. Net premiums earned increased 9 percent in 2014, after advancing 9 percent and 7 percent in 2013 and 2012, respectively. Increased retentions and reduced reinsurance costs have each contributed to the improved results. Premium growth for 2014 was driven by a number of products across our portfolio, as newer product initiatives continued to gain scale and certain established product lines also posted increases. From a segment standpoint, the bulk of the growth during the year was attributable to our casualty segment, where investments in expansion made during recent years has made the most notable impact. With regard to pricing, rates were flat for 2014 on an overall basis. The first half of the year was marked by excess capital in the marketplace, driven by an absence of significant natural catastrophes in 2013 and an influx of alternative capital. This led to reduced reinsurance prices, which resulted in cost savings as we renewed our major property and casualty reinsurance treaties in early 2014. The pressure on reinsurance rates ultimately impacted primary market pricing as well. As a result, positive momentum that existed early in the year gave way to flattening prices as the year progressed. Rates related to catastrophe-exposed coverages in our property segment, however, declined significantly as 2014 represented the second consecutive year of abnormally low natural catastrophe activity. Investment income increased by 5 percent in 2014. The increase was primarily due to a larger invested asset base for most of the year. Additionally, an allocation to higher yielding fixed income securities contributed modestly to the increase. We recorded net realized investment gains on our investment portfolio in each of the past three years. The majority of gains realized over this period related to sales activities versus calls or maturities. Sales activities were the result of normal portfolio rebalancing, as well as raising cash to support special dividends paid in each of the last three years.

| NET EARNINGS<br>(in thousands) | Year ended December 31, |            |            |
|--------------------------------|-------------------------|------------|------------|
|                                | 2014                    | 2013       | 2012       |
| Underwriting income            | \$ 107,019              | \$ 106,793 | \$ 63,593  |
| Net investment income          | 55,608                  | 52,763     | 58,831     |
| Net realized investment gains  | 32,182                  | 22,036     | 25,372     |
| Debt interest                  | (7,438)                 | (8,095)    | (6,050)    |
| Corporate expenses             | (10,222)                | (8,746)    | (7,867)    |
| Investees earnings             | 12,338                  | 10,915     | 8,853      |
| Pretax earnings                | \$ 189,487              | \$ 175,666 | \$ 142,732 |
| Income tax expense             | (54,042)                | (49,411)   | (39,386)   |
| Net earnings                   | \$ 135,445              | \$ 126,255 | \$ 103,346 |

Net earnings increased for the second consecutive year in 2014, after declining in 2012. Results for 2014 reflected both positive underwriting results for the current accident year and favorable loss reserve development on prior accident years. Much like in 2013, a benign catastrophe season and an absence of significant hurricane activity benefited earnings. Catastrophe losses in 2014 and 2013 related primarily to spring storm activity and totaled \$7.2 million and \$10.0 million, respectively. By comparison, 2012 included a much greater impact from catastrophes, as losses related to Hurricane Sandy, Hurricane Isaac and spring storms amounted to \$35.0 million. In total, underwriting income was \$107.0 million in 2014, compared to \$106.8 million in 2013 and \$63.6 million in 2012. Our ability to continue to produce underwriting income, at levels which have consistently outperformed the broader industry, is a testament to our underwriters' discipline throughout the insurance cycle and our continued commitment to underwriting for a profit. We believe our underwriting discipline can differentiate us from the broader insurance market by ensuring appropriate risk selection and pricing of both new and renewal business and can

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serve to slow the pace of deterioration in underwriting results. Since our products must be priced before the ultimate loss costs are known, it may take several years to know if pricing was adequate or inadequate. Inadequate pricing may lead to adverse loss development in future periods. In 2014, we experienced \$64.8 million in favorable development in prior accident years' reserves, compared to favorable development of \$72.5 million in 2013 and \$64.6 million in 2012. Further discussion of reserve development can be found in note 6 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

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. Operating earnings refers to net earnings excluding after-tax net realized investment gains. Return on capital measures components of comprehensive earnings against a minimum required return on capital. Return on capital is the primary measure of executive bonus achievement and a significant component of manager and associate bonus targets. Bonus and profit sharing-related expenses attributable to the favorable reserve developments totaled \$10.6 million, \$11.2 million and \$8.9 million for 2014, 2013 and 2012, respectively. These performance-related expenses impact policy acquisition, insurance operating and general corporate expenses line items in the financial statements. Partially offsetting the 2014, 2013 and 2012 increases were \$1.1 million, \$1.2 million and \$4.2 million, respectively, in reductions to bonus and profit-sharing earned due to losses associated with natural catastrophe activity.

Equity in earnings of unconsolidated investees totaled \$12.3 million in 2014, increasing for the third consecutive year. This amount includes \$12.0 million from Maui Jim, which posted increased sales volume in each of the last three years as a result of continued investments in their business. The combination of increased sales and improved margins resulted in a 10 percent increase in earnings for 2014. The remaining \$0.3 million of equity in earnings of unconsolidated investees relates to Prime, a specialty E&S insurance company. Our equity investment in Prime occurred in the first quarter of 2014. Further discussion of the investment in Prime can be found in note 13 to the consolidated financial statements with Item 8, Financial Statement and Supplementary Data.

**RLI INSURANCE GROUP**

The industry again benefited from a very light catastrophe year in 2014. Pricing momentum slowed during 2014, a contrast from steady improvements experienced in recent years, with rates generally flat on an overall basis. While flat overall, the direction and magnitude of rate changes has varied across our product portfolio. The most noteworthy pricing movements related to catastrophe exposed coverages in our property segment, which sustained double-digit declines in response to competitive pressures in this market. Abnormally low natural catastrophe activity over the past two years and an abundance of capital in the market have been the primary drivers of declining prices for these coverages. Positive pricing trends have been experienced for certain product lines elsewhere in our product portfolio, including umbrella, marine, transportation and specialty personal coverages. In our surety segment, rates remained flat in 2014 as competitive pressures persist in this market. Despite challenging market conditions in 2014, we have managed to grow our top line. Expansion efforts and new product initiatives over the past several years, including our crop reinsurance program, have played a significant role in overall premium production, totaling approximately \$250 million, \$220 million and \$190 million in gross premiums written in 2014, 2013 and 2012, respectively. Excluding premiums from crop, newer initiatives have accounted for approximately 20 percent of gross premiums written in

each of the past three years. The top line impact of crop is noteworthy as our crop reinsurance relationship will expire over the next year due to the acquisition of the cedant. While we expect gross premiums written from crop business to decrease from approximately \$50 million in 2014 to \$10 million in 2015, the impact on underwriting income is expected to be minimal. Gross premiums written, as reflected in the table that follows, increased 2 percent in 2014 after advancing 7 percent in 2013 and 12 percent in 2012. On a net basis, premiums increased 6 percent in 2014 and outpaced growth in gross premiums written due to cost savings realized on our 2014 reinsurance renewals. During the first half of 2014, we renewed all material reinsurance treaties which resulted in over \$16.0 million of annual savings. Net premium growth outpaced gross premiums written growth in 2013 as well, as we increased retentions on certain casualty products where pricing trends were positive.

Across our segments, casualty has been the biggest driver of our growth with gross premiums written advancing in each of the past three years. Premiums increased 6 percent in 2014, following significant growth in 2013 and 2012. Improved pricing for many casualty coverages and new product offerings resulted in premium growth of 17 percent and 20 percent, respectively, for 2013 and 2012. Within our property segment, premium decreased 4 percent in 2014, following a 3 percent decline in 2013 and a 4 percent increase in 2012. Increased competition, rate declines and re-underwriting efforts have served to limit premium production in this book. Gross premiums written from our surety segment increased 4 percent in 2014 after being flat in 2013 and up 7 percent in 2012. While the surety market continues to be highly competitive, our growth is reflective of the CBIC acquisition and other expansion initiatives.

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Our underwriting income and combined ratios are displayed in the following tables. For each of our segments, solid underwriting results were bolstered by favorable development in prior accident years' loss reserves in each of the last three years. The property segment experienced reduced levels of catastrophe losses in 2014 and 2013, following more significant activity in 2012. The following tables and narrative provide a more detailed look at individual segment performance over the last three years.

**GROSS PREMIUMS WRITTEN****(DIRECT & ASSUMED)**

(in thousands)

Year ended December 31,

|          | 2014       | 2013       | 2012       |
|----------|------------|------------|------------|
| Casualty | \$ 482,846 | \$ 456,953 | \$ 391,639 |
| Property | 262,457    | 272,723    | 279,726    |
| Surety   | 118,545    | 113,519    | 113,434    |
| Total    | \$ 863,848 | \$ 843,195 | \$ 784,799 |

**UNDERWRITING INCOME**

(in thousands)

|          | 2014       | 2013       | 2012      |
|----------|------------|------------|-----------|
| Casualty | \$ 45,941  | \$ 55,592  | \$ 25,439 |
| Property | 32,918     | 27,604     | 11,692    |
| Surety   | 28,160     | 23,597     | 26,462    |
| Total    | \$ 107,019 | \$ 106,793 | \$ 63,593 |

| COMBINED RATIO | 2014 | 2013 | 2012 |
|----------------|------|------|------|
| Casualty       | 88.0 | 82.8 | 90.5 |
| Property       | 83.4 | 86.2 | 94.3 |
| Surety         | 73.8 | 77.9 | 75.1 |
| Total          | 84.5 | 83.1 | 89.0 |

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

| NET PREMIUMS EARNED<br>(in thousands) | Year ended December 31, |            |            |
|---------------------------------------|-------------------------|------------|------------|
|                                       | 2014                    | 2013       | 2012       |
| <b>CASUALTY</b>                       |                         |            |            |
| Commercial and personal umbrella      | \$ 100,420              | \$ 85,532  | \$ 68,287  |
| General liability                     | 80,820                  | 81,427     | 84,985     |
| Commercial transportation             | 58,911                  | 50,287     | 34,701     |
| Professional services                 | 58,327                  | 42,063     | 28,018     |
| P&C package business                  | 35,371                  | 30,603     | 28,497     |
| Executive products                    | 18,915                  | 19,123     | 17,198     |
| Medical professional liability        | 15,943                  | 8,626      | 25         |
| Other casualty                        | 13,398                  | 6,361      | 5,986      |
| Total                                 | \$ 382,105              | \$ 324,022 | \$ 267,697 |
| <b>PROPERTY</b>                       |                         |            |            |
| Commercial property                   | \$ 80,719               | \$ 76,939  | \$ 74,197  |
| Marine                                | 49,235                  | 57,122     | 56,367     |
| Crop reinsurance                      | 28,293                  | 31,421     | 24,506     |
| Specialty personal                    | 26,627                  | 16,308     | 12,022     |
| Property reinsurance                  | 12,756                  | 15,770     | 27,021     |
| Other property                        | 146                     | 2,581      | 8,289      |
| Total                                 | \$ 197,776              | \$ 200,141 | \$ 202,402 |
| <b>SURETY</b>                         |                         |            |            |
| Miscellaneous                         | \$ 39,026               | \$ 38,131  | \$ 39,299  |
| Contract                              | 26,592                  | 27,176     | 26,329     |
| Commercial                            | 25,778                  | 23,133     | 22,107     |
| Oil and gas                           | 16,098                  | 18,199     | 18,737     |
| Total                                 | \$ 107,494              | \$ 106,639 | \$ 106,472 |
| Grand total                           | \$ 687,375              | \$ 630,802 | \$ 576,571 |

## Casualty

Casualty gross premiums written of \$482.8 million were up 6 percent in 2014, following an increase of 17 percent in 2013 and 20 percent in 2012. While growth within the segment has slowed relative to recent years, newer product initiatives continue to broaden our product offerings and geographic footprint. Our professional services group posted \$74.2 million in gross premiums written, up 24 percent from the prior year. Since its launch in 2009, this business has continued to achieve year over year growth, most recently due to expanding its product offerings and broadening its target market. In 2013 and 2012, premiums from this book also advanced, up 38 percent and 30 percent, respectively. P&C package premiums totaled \$42.0 million, a 14 percent increase from the prior year, as we continued our efforts to expand geographically. This business was added with the acquisition of CBIC in 2011 and premiums have continued to grow post-acquisition. Premiums from this coverage totaled \$37.0 million for 2013 and \$33.7 million for



2012. Other newer products have also contributed to growth during the year, including security guards coverages, which grew 30 percent, and our new assumed casualty reinsurance business (Prime), which posted gross premiums written of \$10.2 million. This business relates to the reinsurance agreement that accompanied our minority investment in Prime, which occurred in the first quarter of 2014.

On an overall basis, pricing for many casualty coverages was less favorable in 2014, as positive rate momentum slowed during the year. For our more mature product offerings, in particular, this made top line growth challenging. Umbrella premiums declined 2 percent in 2014, following consecutive years of solid growth in 2013 and 2012. Rates for commercial umbrella, which were up nearly 15 percent on average during those periods of growth, leveled off during 2014. Transportation premiums also decreased slightly during the year, down 1 percent to \$71.7 million. The decline in transportation follows a 56 percent increase achieved during 2013 and a 16 percent increase in 2012. Prior to 2012, this book sustained several consecutive years of decline in response to competitive pressures and weak economic conditions, which reduced the revenues upon which insured premiums are based. Premiums from executive products totaled \$50.3 million, slightly improved from prior year, despite a 1 percent decline in rates for these coverages during 2014. In 2013 and 2012, executive products premiums advanced 4 percent and 9 percent, respectively. For general liability, historically our largest product in this segment, gross premiums were flat at \$83.0 million in 2014, after declining 11 percent in 2013 and increasing 4 percent in 2012. While premiums during

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this three year period were favorably impacted by modest price increases, re-underwriting efforts on habitational business, particularly in 2013, negatively impacted the top line. During 2012 and 2013, the habitational component of the general liability book sustained adverse loss experience. Re-underwriting efforts in 2013 led to non-renewal of certain policies and rate increases on others. Prior to re-underwriting, the habitational component represented nearly 50 percent of general liability revenue in 2012. By the end of 2013, this percentage had declined to nearly 25 percent. The increased rates and improved mix of business has resulted in improved current accident year underwriting results in each of the past two years.

On an overall basis, net premium growth outpaced the growth achieved in gross premiums written in each of the last two years. In 2014, net premiums written advanced \$33.4 million (9 percent) while gross premiums advanced \$25.9 million (6 percent). The increased retention is due to cost savings realized during our 2014 reinsurance renewal. In 2013, net premiums written advanced 28 percent while gross premiums advanced 17 percent due largely to increased retentions at our 2013 casualty reinsurance renewal. Given improved pricing on business we underwrite and overall volume growth, particularly in umbrella, we increased retentions on certain casualty products in 2013.

Underwriting income for the casualty segment was \$45.9 million in 2014, compared to \$55.6 million in 2013 and \$25.4 million in 2012. These results translated into combined ratios of 88.0, 82.8 and 90.5 for 2014, 2013 and 2012, respectively. Favorable development on prior accident years' loss reserves totaled \$52.8 million, \$61.8 million and \$40.4 million, for 2014, 2013 and 2012, respectively. In each of these years, actuarial studies indicated that cumulative experience attributable to many casualty coverages for mature accident years was lower than carried reserves, due to favorable loss frequency and severity trends, resulting in the release of reserves. We believe these improved trends are due in part to the quality of our underwriters' risk selection, which has served to offset prior year rate declines and an assumed increase in loss cost trends. In 2014, favorable development was experienced across multiple products. A majority of this favorable development was attributable to accident years 2007 through 2013, with more recent years representing a larger portion of the release. Similarly in 2013, favorable development was experienced across multiple products. Accident years 2005 through 2012 accounted for the majority of favorable experience in 2013. In 2012, favorable development was concentrated in accident years 2007 through 2010.

The segment's loss ratio was 52.1 in 2014, compared to 45.9 in 2013 and 53.8 in 2012. While each year benefited from varying degrees of favorable reserve development on prior accident years, the results also reflect lower current accident year loss ratios relative to previous years. In 2013, modest rate increases, relatively benign loss cost inflation and an improved mix of business resulted in a reduction to the current accident year loss ratio of over 3 points. We have maintained this level of performance on the 2014 current accident year loss ratio. These results follow a 1 point improvement in 2012, which was also driven by an improved rate environment and a shift in mix of business toward lower loss producing products. The expense ratio for the casualty segment was 35.9 in 2014, compared to 36.9 in 2013 and 36.7 in 2012. During each of these periods, we continued to invest in expansion and new product initiatives. Increased revenue from these investments has resulted in improved expense leverage and a lower trending expense ratio.

Property

Gross premiums written in the property segment decreased by 4 percent in 2014 after decreasing 3 percent in 2013 and increasing 4 percent in 2012. Property segment premiums have been pressured by increased competition and re-underwriting actions taken during recent years, which have combined to cause declines for many property coverages. Certain products, however, have provided top-line growth, which partially offset the overall decline seen in 2014. The largest increase was from our recreational vehicle product, which we launched late in the fourth quarter of 2012. Gross written premiums from this book increased \$4.6 million, or 40 percent from 2013, the first full year of operations. Property coverages that experienced premium decreases in 2014 included our marine, commercial property and reinsurance products. Gross premiums written for marine declined in each of the past two years, down 10 percent in 2014 and 7 percent in 2013, after increasing 2 percent in 2012. The decline in marine is due to re-underwriting efforts on the cargo and inland marine books, which included exiting certain unprofitable accounts and increasing rates on others. Overall, these efforts were successful, as marine achieved rate increases of 5 percent and 9 percent in 2014 and 2013, respectively. While premium declined on a full year basis for 2014, production improved in the latter part of the year, reversing the trend of declines seen in recent periods. The re-underwriting of marine business was completed in the second half of 2014.

Commercial property declined 3 percent in 2014 and 2013 after increasing 4 percent in 2012. The 2014 results reflect significant rate declines during the year for catastrophe exposed coverages as an abundance of capital has impacted both reinsurance and primary pricing. Our crop reinsurance business declined 6 percent in 2014, posting premiums of \$50.3 million, compared to \$53.4 million in 2013 and \$35.5 million in 2012. Gross premium growth was significant in 2013 as we increased our participation in the treaty with coverages concentrated in the Midwest. On a net basis, however, premium growth was less dramatic as two-thirds of the premium assumed under the second treaty was ceded to another reinsurance partner. As

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previously noted, we expect reduced premiums from this business going forward. In late 2014, we received a notice of cancellation on the largest portion of our assumed crop business along with notice of a 50 percent reduction on our remaining coverage. Gross and net premiums of approximately \$10 million are expected for 2015, which represents a sizable decrease from recent levels. The impact of this change on underwriting income, however, is expected to be minimal. For other property reinsurance, excluding crop, gross premiums declined to \$13.1 million in 2014, down from \$16.1 million in 2013 and \$37.8 million in 2012. A majority of business assumed in our other property reinsurance program is catastrophe exposed and is viewed as complementary and diversifying for our catastrophe strategy employed within our commercial property product. Where experience is adverse or pricing is deemed inadequate, as occurred in 2014 and 2013, underperforming or underpriced accounts are non-renewed. In addition, our exit from pet insurance in late 2012 negatively impacted premium in 2014 and 2013. Pet insurance contributed \$5.0 million in gross premiums written in 2012.

Underwriting income was \$32.9 million in 2014, compared to \$27.6 million in 2013 and \$11.7 million in 2012. The segment's results translated into combined ratios of 83.4, 86.2 and 94.3 for 2014, 2013 and 2012, respectively. While all three periods were impacted by spring storm losses, the results for 2014 and 2013 reflected an absence of hurricane activity. Results for 2014 included \$4.7 million in spring storm losses and \$0.3 million in losses related to earthquake activity in Napa Valley, which occurred during the third quarter. Favorable development on prior accident years' reserves, primarily from marine, partially offset these losses and improved underwriting results for the segment by \$1.1 million. Results were positive from a current accident year standpoint, as well as re-underwriting efforts on marine and other assumed coverages led to a nearly 3 point improvement in the current accident year loss ratio.

Results for 2013 included \$9.9 million in losses from spring storms, but were devoid of hurricane losses. In addition, results for 2013 were negatively impacted by increased loss activity on marine property coverages, specifically cargo and inland marine. Underwriting actions were taken to increase rates across both coverages, as well as exiting certain underperforming accounts. Partially offsetting these adverse impacts, commercial fire losses remained low and favorable development on prior accident years added \$7.3 million to underwriting income. Approximately half of this benefit related to reductions in prior years' hurricane reserves. The remainder can be attributed to continued positive emergence on marine liability and protection & indemnity coverages. For 2012, underwriting results included elevated natural catastrophe and weather-related losses that impacted our commercial property, marine, crop and other reinsurance coverages. Incurred losses from spring storms totaled \$15.9 million in 2012, while losses and reinstatement premiums from Hurricanes Sandy and Isaac served to reduce income by an additional \$18.1 million. In addition, widespread drought conditions across the United States resulted in our crop coverages posting \$2.0 million in increased underwriting loss on the 2012 reinsurance contracts, when compared to the 2013 reinsurance contract. Partially offsetting these adverse impacts was \$16.8 million in favorable development on prior accident years' reserves. This benefit was due to \$12.1 million in positive emergence on marine liability and protection & indemnity coverages. Reserves related to prior year hurricane and storm losses within commercial property and crop coverages also developed favorably in 2012 and accounted for the balance of favorable development within this segment.

The segment's loss ratio was 45.3 in 2014 compared to 48.1 in 2013 and 57.2 in 2012. The improved result for 2014 related to the aforementioned 3 point decline in the current accident year loss ratio, while increased hurricane and storm activity accounted for the higher loss ratio in 2012. The expense ratio for the property segment was 38.1 in each of the last two years, compared to 37.1 in 2012. Over the three year period, expenses have trended upward slightly due to continued investment in expansion and marginal declines in net premiums earned.

## Surety

Gross premiums written for surety increased 4 percent in 2014, after being flat in 2013 and increasing 7 percent in 2012. The addition of CBIC amplified growth in 2012, its first full year of production, while all periods were influenced by underwriter additions and geographic expansion. Commercial surety was the primary driver of growth during 2014, increasing 15 percent to \$30.4 million, due, in part, to writing additional bonds for our existing accounts. Contract surety also improved, up 3 percent. Commercial and contract surety have increased top line production in each of the past three years. Miscellaneous surety increased 3 percent in 2014, after falling 1 percent in the prior year and increasing 11 percent 2012. Partially offsetting this growth was oil and gas surety, which declined 9 percent in 2014 and 5 percent in 2013, after being flat in 2012. Falling energy prices in recent periods have impacted premium from this product. On an overall basis, premium within the segment continues to be challenged by increased competition from new entrants into this market.

Underwriting income totaled \$28.2 million in 2014, compared to \$23.6 million in 2013 and \$26.5 million in 2012. The segment's results translated into combined ratios of 73.8, 77.9 and 75.1 for 2014, 2013 and 2012, respectively. The segment's loss ratio was 7.3 in 2014, compared to 13.8 in 2013 and 11.1 in 2012. Underwriting performance for each of these years

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reflects a combination of positive current accident year results and favorable development in prior accident years' loss reserves. While all three years benefited from favorable development, the amount in 2014 was \$7.5 million higher than in 2013. This increase resulted in the reduced loss ratio in 2014. Results for 2014 were also impacted by \$1.3 million of reinsurance reinstatement premium related to unfavorable development on prior years' surety reserves. The expense ratio for the segment was 66.5 in 2014, compared to 64.1 in 2013 and 64.0 in 2012. The increase in 2014 was due to the combined effect of shifts in mix toward products with higher acquisition expense rates, increased commissions and the impact of the above-mentioned reinstatement premium.

## NET INVESTMENT INCOME AND REALIZED INVESTMENT GAINS

During 2014, net investment income increased by 5 percent. The increase was primarily due to a larger invested asset base for most of the year. Additionally, an allocation to some higher yielding fixed income securities contributed modestly to the increase. The average annual yields on our investments were as follows for 2014, 2013 and 2012:

|                            | 2014   | 2013   | 2012   |
|----------------------------|--------|--------|--------|
| <b>PRETAX YIELD</b>        |        |        |        |
| Taxable (on book value)    | 3.58 % | 3.66 % | 3.75 % |
| Tax-exempt (on book value) | 2.79 % | 2.70 % | 2.76 % |
| Equities (on fair value)   | 2.83 % | 2.95 % | 3.18 % |
| <b>AFTER-TAX YIELD</b>     |        |        |        |
| Taxable (on book value)    | 2.33 % | 2.38 % | 2.44 % |
| Tax-exempt (on book value) | 2.64 % | 2.56 % | 2.61 % |
| Equities (on fair value)   | 2.43 % | 2.53 % | 2.73 % |

The after-tax yield reflects the different tax rates applicable to each category of investment. Our taxable fixed income securities are subject to our corporate tax rate of 35.0 percent, our tax-exempt municipal securities are subject to a tax rate of 5.3 percent and our dividend income is generally subject to a tax rate of 14.2 percent. During 2014, the average after-tax yield on the taxable fixed income portfolio declined to 2.3 percent from 2.4 percent in 2013, while the average after-tax yield on the tax-exempt portfolio increased slightly.

The fixed income portfolio increased by \$54.4 million during the year as unrealized gains increased due to declining interest rates and operating cash flows contributed to net purchases. During 2014, the portfolio experienced net realized gains of \$4.0 million and ended 2014 with net unrealized gains of \$46.9 million. The tax-adjusted total return on a mark-to-market basis was 6.5 percent. During 2014, our equity portfolio decreased by \$8.0 million to \$410.6 million.

During 2014, our equity portfolio experienced net realized gains of \$29.5 million and ended 2014 with net unrealized gains of \$217.1 million. The total return for the year on the equity portfolio was 14.7 percent.

Our investment results for the last five years are shown in the following table:

| (in thousands) | Average<br>Invested<br>Assets (1) | Net<br>Investment<br>Income (2)(3) | Net Realized<br>Gains<br>(Losses) (3) | Change in<br>Unrealized<br>Appreciation<br>(3)(4) | Annualized<br>Return on<br>Avg.<br>Invested<br>Assets |   | Tax<br>Equivalent<br>Annualized<br>Return on<br>Avg.<br>Invested<br>Assets |   |
|----------------|-----------------------------------|------------------------------------|---------------------------------------|---|---|---|--|---|
| 2010           | 1,827,761                         | 66,799                             | 23,243                                | 28,695  | 6.5   | % | 6.8  | % |
| 2011           | 1,851,654                         | 63,681                             | 17,036                                | 32,855  | 6.1   | % | 6.3  | % |
| 2012           | 1,870,584                         | 58,831                             | 25,372                                | 39,855  | 6.6   | % | 6.9  | % |
| 2013           | 1,881,470                         | 52,763                             | 22,036                                | (10,923)  | 3.4   | % | 3.7  | % |
| 2014           | 1,943,172                         | 55,608                             | 32,182                                | 55,180  | 7.4   | % | 7.7  | % |
| 5-yr Avg.      | \$ 1,874,928                      | \$ 59,536                          | \$ 23,974                             | \$ 29,132   | 6.0   | % | 6.3  | % |

(1) Average amounts at beginning and end of year (inclusive of cash and short-term investments).

(2) Investment income, net of investment expenses.

(3) Before income taxes.

(4) Relates to available-for-sale fixed income and equity securities.

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We realized a total of \$32.2 million in net investment gains in 2014. Included in this number is \$29.5 million in net realized gains in the equity portfolio, \$4.0 million in net realized gains in the fixed income portfolio and \$1.3 million in other net realized losses. In 2013, we realized \$22.0 million in net investment gains. Included in this number is \$21.5 million in net realized gains in the equity portfolio, \$1.3 million in net realized gains in the fixed income portfolio and \$0.8 million in other net realized losses. In 2012, we realized \$25.4 million in net investment gains. We realized \$15.1 million in net realized gains in the equity portfolio, \$13.2 million in net realized gains in the fixed income portfolio and \$2.9 million in net realized losses inclusive of an impairment of a long-lived asset.

We regularly evaluate the quality of our investment portfolio. When we determine that a specific security has suffered an other-than-temporary decline in value, the investment's value is adjusted by reclassifying the decline from unrealized to realized losses. This has no impact on shareholders' equity. We did not recognize any OTTI losses during 2014 or 2013. During 2012, we recognized \$1.2 million in impairment losses. All losses were taken during the second quarter on equity securities we no longer had the intent to hold.

As of December 31, 2014, we held four securities in our equity portfolio that were in unrealized loss positions. The total unrealized loss on these securities was \$1.0 million. With respect to both the significance and duration of the unrealized loss positions, we have no equity securities in an unrealized loss position of greater than 20 percent for more than six consecutive months.

The fixed income portfolio contained 258 positions at an unrealized loss as of December 31, 2014. Of these 258 securities, 49 have been in an unrealized loss position for 12 consecutive months or longer and represent \$1.7 million in unrealized losses. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. Based on our analysis, our fixed income portfolio is of a high credit quality and we believe we will recover the amortized cost basis.

Key components to our OTTI procedures are discussed in our critical accounting policy on investment valuation and OTTI and in note 2 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data. Based on our analysis, we have concluded that the securities in an unrealized loss position were not other-than-temporarily impaired at December 31, 2014.

INVESTMENTS

We maintain a diversified investment portfolio with an 80 percent fixed income and 20 percent equity target. We continually monitor economic conditions, our capital position and the insurance market to determine our tactical equity allocation. As of December 31, 2014, the portfolio had a fair value of \$2.0 billion, an increase of \$42.2 million



from the end of 2013.

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. For additional information, see notes 1 and 2 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

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

## PORTFOLIO ALLOCATION

(in thousands)

| Asset Class            | Cost or<br>Amortized<br>Cost | Fair Value   | Unrealized<br>Gain/(Loss) | % of Total<br>Fair Value | Quality* |
|------------------------|------------------------------|--------------|---------------------------|--------------------------|----------|
| U.S. agency            | \$ 6,385                     | \$ 6,747     | \$ 362                    | 0.3                      | % AA     |
| Corporate              | 543,183                      | 562,690      | 19,507                    | 28.7                     | % BBB    |
| Agency MBS             | 256,443                      | 264,468      | 8,025                     | 13.5                     | % AA     |
| ABS/CMBS**             | 133,894                      | 135,304      | 1,410                     | 6.9                      | % AAA    |
| Non-U.S. govt & agency | 9,862                        | 10,665       | 803                       | 0.5                      | % A      |
| U. S. government       | 33,668                       | 33,788       | 120                       | 1.7                      | % AA     |
| Municipal              | 464,769                      | 481,425      | 16,656                    | 24.5                     | % AA     |
| Total fixed income     | \$ 1,448,204                 | \$ 1,495,087 | \$ 46,883                 | 76.1                     | % AA     |
| Equities               | \$ 193,535                   | \$ 410,642   | \$ 217,107                | 20.9                     | %        |
| Short-term investments | \$ 16,339                    | \$ 16,339    | \$ —                      | 0.8                      | %        |
| Other invested assets  | 11,597                       | 11,597       | —                         | 0.6                      | %        |
| Cash                   | 30,620                       | 30,620       | —                         | 1.6                      | %        |
| Total portfolio        | \$ 1,700,295                 | \$ 1,964,285 | \$ 263,990                | 100.0                    | %        |

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

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

Quality in the previous table and in all subsequent tables is an average of each bond's credit rating, adjusted for its relative weighting in the portfolio.

Fixed income represented 76 percent of our total 2014 portfolio compared to 75 percent in 2013. As of December 31, 2014, the fair value of our fixed income portfolio consisted of 17 percent AAA-rated securities, 45 percent AA-rated securities, 22 percent A-rated securities, 10 percent BBB-rated securities and 6 percent non-investment grade or non-rated securities. This compares to 17 percent AAA-rated securities, 46 percent AA-rated securities, 25 percent A-rated securities and 11 percent BBB-rated securities in 2013.

In selecting the maturity of securities in which we invest, we consider the relationship between the duration of our fixed income investments and the duration of our liabilities, including the expected ultimate payout patterns of our reserves. We believe that both liquidity and interest rate risk can be minimized by such asset/liability management. As of December 31, 2014, our fixed income portfolio's duration was 4.6 years.

Our equity portfolio had a fair value of \$410.6 million at December 31, 2014, entirely classified as available-for-sale. Equities comprised 21 percent of our total 2014 portfolio, down from 22 percent in 2013. Securities within the equity portfolio are well diversified and are primarily invested in large-cap issues with a focus on dividend income. Our strategy is value oriented and security selection takes precedence over market timing. Likewise, low turnover throughout our long investment horizon minimizes transaction costs and taxes.

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## FIXED INCOME PORTFOLIO

As of December 31, 2014, our fixed income portfolio had the following rating distributions:

| FAIR VALUE<br>(in thousands)                      | AAA     | AA         | A          | BBB       | Below<br>Investment<br>Grade | No Rating | Fair Value |
|---|---------|------------|------------|-----------|------------------------------|-----------|------------|
| Bonds:  |         |            |            |           |                              |           |            |
| Corporate -<br>financial                          | \$ —    | \$ 11,156  | \$ 126,455 | \$ 48,375 | \$ 11,904                    | \$ —      | \$ 197,890 |
| All other<br>corporate                            | —       | 18,131     | 125,671    | 87,166    | 74,462                       | —         | 305,430    |
| Corporate<br>financial -<br>private<br>placements | —       | 11,242     | 17,859     | 4,317     | —                            | —         | 33,418     |
| All other<br>corporate -<br>private<br>placements | —       | 5,132      | 10,027     | 10,793    | —                            | —         | 25,952     |
| U.S.<br>government &<br>agency (GSE)              | —       | 40,535     | —          | —         | —                            | —         | 40,535     |
| Non-U.S.<br>government &<br>agency                | —       | 5,505      | 3,120      | 2,040     | —                            | —         | 10,665     |
| Municipal   | 129,216 | 305,412    | 45,602     | —         | —                            | 1,195     | 481,425    |
| Structured:                                       |         |            |            |           |                              |           |            |
| GSE - RMBS  | \$ —    | \$ 242,823 | \$ —       | \$ —      | \$ —                         | \$ —      | \$ 242,823 |
| Non-GSE<br>RMBS - prime                           | —       | —          | —          | —         | —                            | —         | —          |
| Non-GSE<br>RMBS - Alt A                           | —       | —          | —          | —         | —                            | —         | —          |
| Non-GSE<br>RMBS -<br>subprime                     | —       | —          | —          | —         | —                            | —         | —          |
| ABS - utility                                     | 11,417  | —          | —          | —         | —                            | —         | 11,417     |
| ABS - credit<br>cards                             | 12,380  | —          | —          | —         | —                            | —         | 12,380     |
| ABS - auto<br>loans                               | 17,265  | —          | —          | —         | —                            | —         | 17,265     |
| All other ABS                                     | 3,015   | 1,479      | —          | —         | —                            | —         | 4,494      |
| GSE - CMBS  | —       | 21,645     | —          | —         | —                            | —         | 21,645     |
| CMBS  | 83,683  | 6,065      | —          | —         | —                            | —         | 89,748     |

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|           |            |            |            |            |           |          |              |
|-----------|------------|------------|------------|------------|-----------|----------|--------------|
| CDOs/CLOs | —          | —          | —          | —          | —         | —        | —            |
| Total     | \$ 256,976 | \$ 669,125 | \$ 328,734 | \$ 152,691 | \$ 86,366 | \$ 1,195 | \$ 1,495,087 |

Mortgage-Backed, Commercial Mortgage-Backed and Asset-Backed Securities

The following table summarizes the distribution of our mortgage-backed securities (MBS) portfolio by investment type, as of the dates indicated:

AGENCY MBS

| (in thousands)             | Amortized<br>Cost | Fair Value | % of Total |   |
|----------------------------|-------------------|------------|------------|---|
| 2014                       |                   |            |            |   |
| Planned amortization class | \$ 41,231         | \$ 41,320  | 16         | % |
| Sequential                 | 21,812            | 21,645     | 8          | % |
| Pass-throughs              | 193,400           | 201,503    | 76         | % |
| Total                      | \$ 256,443        | \$ 264,468 | 100        | % |
| 2013                       |                   |            |            |   |
| Planned amortization class | \$ 39,339         | \$ 38,259  | 16         | % |
| Sequential                 | 16,472            | 16,167     | 6          | % |
| Pass-throughs              | 187,621           | 189,990    | 78         | % |
| Total                      | \$ 243,432        | \$ 244,416 | 100        | % |

Our allocation to agency mortgage-backed securities totaled \$264.5 million as of December 31, 2014. MBS represented 18 percent of the fixed income portfolio compared to \$244.4 million or 17 percent of that portfolio as of December 31, 2013.

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We believe MBS investments add diversification, liquidity, credit quality and additional yield to our portfolio. Our objective for the MBS portfolio is to provide reasonable cash flow stability where we are compensated for the call risk associated with residential refinancing. The MBS portfolio includes mortgage-backed pass-through securities and collateralized mortgage obligations (CMO). A mortgage pass-through is a security consisting of a pool of residential mortgage loans which returns principal and interest cash flows to investors each month. A CMO has a more finite payment structure and can reduce the risks associated with prepayment. CMO securities are divided into maturity classes that are paid off under certain expected interest rate conditions. Our MBS portfolio does not include interest-only securities or principal-only securities. As of December 31, 2014, all of the securities in our MBS portfolio were rated AA+ and issued by Government Sponsored Enterprises (GSEs) such as the Governmental National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC).

Variability in the average life of principal repayment is an inherent risk of owning mortgage-related securities. However, we reduce our portfolio's exposure to prepayment risk by seeking characteristics that tighten the probable scenarios for expected cash flows. As of December 31, 2014, the MBS portfolio contained 76 percent of pure pass-throughs compared to 78 percent as of December 31, 2013. An additional 16 percent of the MBS portfolio was invested in planned amortization class CMOs (PACs), the same as 2013. CMO PACs are securities whose cash flows are designed to remain constant in a variety of mortgage prepayment environments.

The following table summarizes the distribution of our asset-backed and commercial mortgage-backed securities portfolio as of the dates indicated:

## ABS/CMBS

| (in thousands) | Amortized  |            |            |   |
|----------------|------------|------------|------------|---|
|                | Cost       | Fair Value | % of Total |   |
| 2014           |            |            |            |   |
| CMBS           | \$ 88,509  | \$ 89,748  | 66         | % |
| Auto           | 17,266     | 17,265     | 13         | % |
| Business       | 1,493      | 1,479      | 1          | % |
| Equipment      | 3,030      | 3,015      | 2          | % |
| Utility        | 11,402     | 11,417     | 9          | % |
| Credit card    | 12,194     | 12,380     | 9          | % |
| Total          | \$ 133,894 | \$ 135,304 | 100        | % |
| 2013           |            |            |            |   |
| CMBS           | \$ 88,113  | \$ 87,510  | 82         | % |
| Auto           | 7,514      | 7,516      | 7          | % |
| Business       | —          | —          | —          | % |
| Equipment      | —          | —          | —          | % |
| Utility        | 4,979      | 5,065      | 5          | % |
| Credit card    | 6,149      | 6,218      | 6          | % |
| Total          | \$ 106,755 | \$ 106,309 | 100        | % |

An asset-backed security (ABS) or commercial mortgage-backed security (CMBS) is a securitization collateralized by the cash flows from a specific pool of underlying assets. These asset pools can include items such as credit card payments, auto loans and residential or commercial mortgages. As of December 31, 2014, ABS/CMBS investments were \$135.3 million (9 percent) of the fixed income portfolio, compared to \$106.3 million (7 percent) as of December 31, 2013. The entire ABS/CMBS portfolio was rated AA or higher as of December 31, 2014. We believe that ABS/CMBS investments add diversification and additional yield to the portfolio while often adding superior cash flow stability over mortgage pass-throughs or CMOs.

When making investments in MBS/ABS/CMBS, we evaluate the quality of the underlying collateral, the structure of the transaction (which dictates how any losses in the underlying collateral will be distributed) and prepayment risks. All of our collateralized securities carry the highest credit rating by one or more major rating agency and continue to pay according to contractual terms. We had \$0.4 million in unrealized losses in this asset class as of December 31, 2014.

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## Municipal Fixed Income Securities

As of December 31, 2014, municipal bonds totaled \$481.4 million (32 percent) of our fixed income portfolio, compared to \$522.7 million (36 percent) as of December 31, 2013. We decreased our allocation to the sector as tax-exempt municipal spreads tightened throughout the year. We believe municipal fixed income securities can provide diversification and additional tax-advantaged yield to our portfolio. Our objective for the municipal fixed income portfolio is to provide reasonable cash flow stability and increased after-tax yield.

Our municipal fixed income portfolio is comprised of general obligation (GO) and revenue securities. The revenue sources include sectors such as sewer and water, public improvement, school, transportation and colleges and universities.

As of December 31, 2014, approximately 49 percent of the municipal fixed income securities in the investment portfolio were GO and the remaining 51 percent were revenue based. Ninety percent of our municipal fixed income securities were rated AA or better, while 99 percent were rated A or better.

## Corporate Debt Securities

As of December 31, 2014, our corporate debt portfolio totaled \$562.7 million (38 percent) of the fixed income portfolio compared to \$526.0 million (37 percent) as of December 31, 2013. Our allocation to the corporate debt portfolio increased during the year as we initiated an investment allocation to high-yield credit. This portfolio consists of floating rate bank loans and bonds that are below investment grade in credit quality and offer incremental yield over our core fixed income portfolio. The corporate debt portfolio has an overall quality rating of BBB, diversified among 378 issues.

The following table illustrates our corporate debt exposure to the financial and non-financial sectors as of December 31, 2014, including fair value, cost basis and unrealized gains and losses:

## CORPORATES

| (in thousands)        | Amortized<br>Cost | Fair Value | Gross<br>Unrealized<br>Gains | Gross<br>unrealized<br>losses |
|-----------------------|-------------------|------------|------------------------------|-------------------------------|
| Bonds:                |                   |            |                              |                               |
| Corporate - financial | \$ 187,436        | \$ 197,890 | \$ 11,306                    | \$ (852)                      |



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|  |            |            |           |            |
|--|------------|------------|-----------|------------|
| All other corporate                      | 299,447    | 305,430    | 9,311     | (3,328)    |
| Financials - private placements          | 31,187     | 33,418     | 2,231     | —          |
| All other corporate - private placements | 25,113     | 25,952     | 849       | (10)       |
| Total                                    | \$ 543,183 | \$ 562,690 | \$ 23,697 | \$ (4,190) |

We believe corporate debt investments add diversification and additional yield to our portfolio. Because corporates make up a large portion of the fixed income opportunity set, the corporate debt investments will continue to be a significant part of our investment program.

The amortized cost and fair value of fixed income securities at December 31, 2014, by contractual maturity, are shown as follows:

| TOTAL FIXED INCOME<br>(in thousands)  | Amortized Cost | Fair Value   |
|---------------------------------------|----------------|--------------|
| Due in one year or less               | \$ 19,147      | \$ 19,368    |
| Due after one year through five years | 219,567        | 229,146      |
| Due after five years through 10 years | 570,196        | 587,807      |
| Due after 10 years                    | 248,956        | 258,994      |
| Mtge/ABS/CMBS*                        | 390,338        | 399,772      |
| Total fixed income                    | \$ 1,448,204   | \$ 1,495,087 |

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

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## EQUITY SECURITIES

As of December 31, 2014, our equity portfolio totaled \$410.6 million (21 percent) of the investment portfolio, compared to \$418.7 million (22 percent) as of December 31, 2013. Our common stock portfolio decreased in the normal course of rebalancing the position throughout the year. The securities within the equity portfolio remain primarily invested in large-cap issues with a focus on dividend income. In addition, we have investments in three broadly diversified, exchange traded funds (ETFs) that represent market indexes similar to the Russell 1000 Index, the S&P 500 Index, and the S&P 500 Utilities Index. No one fund makes up more than 50 percent of the ETF allocation, and the philosophy mirrors that of the actively managed equity portfolio, with a preference for dividend income and lower anticipated volatility than the market (as measured by the S&P 500). We did not recognize any impairment losses in the equity portfolio during 2014 or 2013.

The following table illustrates the distribution by sector of our equity portfolio as of December 31, 2014, including fair value, cost basis and unrealized gains and losses:

| (in thousands)         | Cost Basis | Fair Value | % of Total<br>Fair Value | Net<br>Unrealized<br>Gain/Loss |
|------------------------|------------|------------|--------------------------|--------------------------------|
| Common stock:          |            |            |                          |                                |
| Consumer discretionary | \$ 15,592  | \$ 32,288  | 7.9                      | % \$ 16,696                    |
| Consumer staples       | 13,096     | 36,414     | 8.9                      | % 23,318                       |
| Energy                 | 11,464     | 27,252     | 6.6                      | % 15,788                       |
| Financials             | 22,284     | 43,632     | 10.6                     | % 21,348                       |
| Healthcare             | 5,586      | 25,294     | 6.2                      | % 19,708                       |
| Industrials            | 17,024     | 35,285     | 8.6                      | % 18,261                       |
| Information technology | 16,488     | 32,053     | 7.8                      | % 15,565                       |
| Materials              | 2,220      | 7,053      | 1.7                      | % 4,833                        |
| Telecommunications     | 7,062      | 13,964     | 3.4                      | % 6,902                        |
| Utilities              | 34,466     | 67,551     | 16.4                     | % 33,085                       |
| ETFs                   | 48,253     | 89,856     | 21.9                     | % 41,603                       |
| Total                  | \$ 193,535 | \$ 410,642 | 100.0                    | % \$ 217,107                   |

## INTEREST AND CORPORATE EXPENSE

We incurred \$7.4 million of interest expense on outstanding debt during 2014, compared to \$8.1 million in 2013 and \$6.0 million in 2012. We completed a public debt offering in October 2013, issuing \$150.0 million in senior notes, and used a portion of the proceeds to repay \$100.0 million in senior notes that were originally set to mature in January 2014. Due to the timing of the transaction settlements associated with the new debt issuance and repayment of the 2014 notes, our weighted average debt balance was slightly higher in 2013, resulting in the higher interest

expense. At December 31, 2014 and 2013, our long-term debt consisted of \$150.0 million in senior notes maturing September 15, 2023, and paying interest semi-annually at the rate of 4.875 percent. At December 31, 2012, our long-term debt consisted of \$100.0 million in senior notes that paid interest semi-annually at the rate of 5.95 percent.

As discussed previously, general corporate expenses tend to fluctuate relative to our incentive compensation plans. Our compensation model measures components of comprehensive earnings against a minimum required return on our capital. Bonuses are earned as we generate earnings in excess of this required return. In 2014, 2013 and 2012, we exceeded the required return, resulting in the accrual of executive bonuses. Excluding this variable component tied to performance, other general corporate expenses increased in 2014 due in part to increased shareholder-related expenses, including costs associated with the stock-split and higher legal fees associated with corporate litigation arising in 2014. In 2013 and 2012, other general corporate expenses were flat.

#### INVESTEE EARNINGS

We maintain a 40 percent equity interest in Maui Jim, a manufacturer of high-quality polarized sunglasses. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim. Maui Jim is a private company, and as such, the market for its stock is limited. Our investment in Maui Jim is carried at the holding company, RLI Corp., level as it is not core to our insurance operations. As a minority shareholder, we are subject to the decisions of the controlling shareholder, which may impact the value of our investment. In 2014, we recorded \$12.0 million in earnings from this

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investment compared to \$10.9 million in 2013 and \$8.9 million in 2012. Sunglass sales were up 14 percent in 2014, after increasing 6 percent in 2013 and 4 percent in 2012. Improved cost of sales also benefited earnings in 2014.

In 2014, 2013 and 2012, we received dividends from Maui Jim. Dividends from Maui Jim have been irregular in nature and while they provide added liquidity when received, we do not rely on those dividends to meet our liquidity needs. While these dividends do not flow through the investee earnings line, they do result in the recognition of a tax benefit, which is discussed in the income tax section that follows.

On February 5, 2014, we invested \$5.3 million for a 20 percent equity ownership interest in Prime, an Illinois domiciled insurance carrier based in Salt Lake City, Utah. Prime is a privately-held excess and surplus lines insurance company that distributes its products through a network of wholesale brokers and specializes in hard-to-place risks. Our investment in Prime was \$5.7 million at December 31, 2014 and we recorded \$0.3 million in investee earnings during the year. Additionally, we entered into a 25 percent quota share reinsurance treaty with Prime, effective January 1, 2014, which contributed \$10.2 million of gross premiums written and \$5.3 million of net premiums earned during the year.

INCOME TAXES

Our effective tax rates were 28.5 percent, 28.1 percent and 27.6 percent for 2014, 2013 and 2012, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2014 was higher than 2013 due to an increase in net realized gains on investments along with a slight increase in underwriting income.

Dividends paid to our Employee Stock Ownership Plan (ESOP) result in a tax deduction. Special dividends paid to the ESOP in 2014, 2013 and 2012 resulted in tax benefits of \$3.6 million, \$1.7 million and \$2.9 million, respectively. These tax benefits reduced the effective tax rate for 2014, 2013 and 2012 by 1.9 percent, 1.0 percent and 2.0 percent, respectively.

Our net earnings include equity in earnings of unconsolidated investees, Maui Jim and Prime. The investees do not have a policy or pattern of paying dividends. As a result, we record a deferred tax liability on the earnings at the corporate capital gains rate of 35 percent. In the fourth quarters of 2014, 2013 and 2012, we received a \$6.6 million, \$13.2 million and \$6.6 million dividend from Maui Jim, respectively. In accordance with GAAP guidelines on income taxes, we recognized a \$1.8 million, \$3.7 million and \$1.8 million tax benefit for 2014, 2013 and 2012 respectively. The tax benefit is generated from applying the lower tax rate applicable to affiliated dividends (7 percent), as compared to the corporate capital gains rate on which the deferred tax liabilities were based. Standing alone, the dividend resulted in a 1.0 percent, 2.1 percent and 1.3 percent reduction to the 2014, 2013 and 2012 effective tax rates, respectively. In determining the appropriate tax rate to apply, we anticipate recovering our investments through means

other than the receipt of dividends, such as a sale.

In addition, our pretax earnings in 2014 included \$25.3 million of investment income that is partially exempt from federal income tax, compared to \$24.5 million and \$22.7 million in 2013 and 2012, respectively.

#### NET UNPAID LOSSES AND SETTLEMENT EXPENSES

The primary liability on our balance sheet relates to unpaid losses and settlement expenses, which represents our estimated liability for losses and related settlement expenses before considering offsetting reinsurance balances recoverable. The largest asset on our balance sheet, outside of investments, is the reinsurance balances recoverable on unpaid losses and settlement expenses, which serves to offset this liability.

The liability can be split into two parts: (1) case reserves representing estimates of losses and settlement expenses on known claims and (2) IBNR reserves representing estimates of losses and settlement expenses on claims that have occurred but have not yet been reported to us. Our gross liability for both case and IBNR reserves is reduced by reinsurance balances recoverable on unpaid losses and settlement expenses to calculate our net reserve balance. This net reserve balance increased to \$785.9 million at December 31, 2014, from \$774.5 million as of December 31, 2013. This reflects incurred losses of \$296.6 million in 2014 offset by paid losses of \$285.2 million compared to incurred losses of \$259.8 million offset by \$283.9 million paid in 2013. The overall increase in our net loss and LAE reserves between 2014 and 2013 was small, but there were changes by segment as discussed in note 6 to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

Gross reserves (liability) and the reinsurance balances recoverable (asset) were both subject to the same influences that affected net reserves and behaved similarly. Total gross and ceded loss and LAE reserves decreased to \$1.12 billion and \$335.1 million, respectively, at December 31, 2014, from \$1.13 billion and \$354.9 million, respectively, at December 31, 2013.

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## LIQUIDITY AND CAPITAL RESOURCES

## OVERVIEW

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

| (in thousands)              | 2014       | 2013       | 2012      |
|-----------------------------|------------|------------|-----------|
| Operating cash flows        | \$ 123,085 | \$ 134,966 | \$ 36,240 |
| Investing cash flows (uses) | 22,771     | (101,932)  | 52,352    |
| Financing cash flows (uses) | (154,705)  | (37,879)   | (125,462) |

We have posted positive operating cash flow in each of the last three years. Variations in operating cash flow between periods are largely driven by the volume and timing of premium receipt, claim payments, reinsurance and taxes. In addition, fluctuations in insurance operating expenses impact operating cash flow. Operating cash flows in 2012 are lower than 2013 and 2014 largely due to the return of a \$50.0 million cash deposit that was being held for a commercial surety customer in lieu of a letter of credit. During 2014 and 2012, the majority of cash flows were used in financing activities, due largely to the payment of special dividends. Financing cash flows noted in the above table include special dividends totaling \$129.3 million, \$64.5 million and \$106.3 million for 2014, 2013 and 2012, respectively. In 2013, cash flows also reflect a net financing cash inflow related to our public debt offering.

We have entered into certain contractual obligations that require us to make recurring payments. The following table summarizes our contractual obligations as of December 31, 2014.

## CONTRACTUAL OBLIGATIONS

| (in thousands)                       | Payments due by period |            |            |                  | Total        |
|--------------------------------------|------------------------|------------|------------|------------------|--------------|
|                                      | Less than 1 yr.        | 1-3 yrs.   | 3-5 yrs.   | More than 5 yrs. |              |
| Loss and settlement expense reserves | \$ 311,710             | \$ 412,831 | \$ 201,409 | \$ 195,090       | \$ 1,121,040 |
| Long-term debt                       | —                      | —          | —          | 150,000          | 150,000      |
| Operating leases                     | 4,810                  | 6,815      | 3,677      | 4,621            | 19,923       |

|       |            |            |            |            |              |
|-------|------------|------------|------------|------------|--------------|
| Total | \$ 316,520 | \$ 419,646 | \$ 205,086 | \$ 349,711 | \$ 1,290,963 |
|-------|------------|------------|------------|------------|--------------|

Loss and settlement expense reserves represent our best estimate of the ultimate cost of settling reported and unreported claims and related expenses. As discussed previously, the estimation of loss and loss expense reserves is based on various complex and subjective judgments. Actual losses and settlement expenses paid may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements. Similarly, the timing for payment of our estimated losses is not fixed and is not determinable on an individual or aggregate basis. The assumptions used in estimating the payments due by periods are based on our historical claims payment experience. Due to the uncertainty inherent in the process of estimating the timing of such payments, there is a risk that the amounts paid in any period can be significantly different than the amounts disclosed above. Amounts disclosed above are gross of anticipated amounts recoverable from reinsurers. Reinsurance balances recoverable on unpaid loss and settlement reserves are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not discharge us of our liability to policyholders. Reinsurance balances recoverable on unpaid loss and settlement reserves totaled \$335.1 million at December 31, 2014, compared to \$354.9 million in 2013.

The next largest contractual obligation relates to long-term debt outstanding. On October 2, 2013, we completed a public debt offering of \$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. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$148.6 million. We are not party to any off-balance sheet arrangements.

Our primary objective in managing our capital is to preserve and grow shareholders' equity and statutory surplus to improve our competitive position and allow for expansion of our insurance operations. Our insurance subsidiaries must maintain certain minimum capital levels in order to meet the requirements of the states in which we are regulated. Our insurance companies are also evaluated by rating agencies that assign financial strength ratings that measure our ability to meet our obligations to policyholders over an extended period of time.

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We have historically grown our shareholders' equity and/or policyholders' surplus as a result of three sources of funds: (1) earnings on underwriting and investing activities, (2) appreciation in the value of our invested assets and (3) the issuance of common stock and debt.

At December 31, 2014, we had cash, short-term investments and other investments maturing within one year of approximately \$66.3 million and an additional \$253.1 million of investments maturing between 1 to 5 years. We 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 year ended December 31, 2014, no amounts were outstanding on the revolving line of credit.

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. According to our current membership, aggregate borrowing capacity is approximately \$40 million at year end. However, under certain circumstances, that capacity may be increased based on additional FHLBC stock purchased and available collateral. Our membership allows each insurance subsidiary to determine tenor and structure at the time of borrowing. As of and during the year ended December 31, 2014, no amounts were outstanding with the FHLBC.

We believe that cash generated by operations, cash generated by investments and 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 generated positive operating cash flow for more than 20 consecutive years. The primary factor in our ability to generate positive operating cash flow is underwriting profitability, which we have achieved for 19 consecutive years.

OPERATING ACTIVITIES

The following list highlights some of the major sources and uses of cash flow from operating activities:

|  |                             |
|--|-----------------------------|
| Sources                                  | Uses                        |
| Premiums received                        | Claims                      |
|  | Ceded premium to reinsurers |
| Loss payments from reinsurers            | Commissions paid            |
| Investment income (interest & dividends) |                             |



Unconsolidated investee dividends from affiliates

Operating expenses

Interest expense

Income taxes

Our largest source of cash is from premiums received from our customers, which we receive at the beginning of the coverage period for most policies. Our largest cash outflow is for claims that arise when a policyholder incurs an insured loss. Because the payment of claims occurs after the receipt of the premium, often years later, we invest the cash in various investment securities that earn interest and dividends. We use cash to pay commissions to brokers and agents, as well as to pay for ongoing operating expenses such as salaries, rent, taxes and interest expense. We also utilize reinsurance to manage the risk that we take on our policies. We cede, or pay out, part of the premiums we receive to our reinsurers and collect cash back when losses subject to our reinsurance coverage are paid.

The timing of our cash flows from operating activities can vary among periods due to the timing by which payments are made or received. Some of our payments and receipts, including loss settlements and subsequent reinsurance receipts, can be significant, so their timing can influence cash flows from operating activities in any given period. We are subject to the risk of incurring significant losses on catastrophes, both natural (such as earthquakes and hurricanes) and man-made (such as terrorism). If we were to incur such losses, we would have to make significant claims payments in a relatively concentrated period of time.

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INVESTING ACTIVITIES

The following list highlights some of the major sources and uses of cash flow from investing activities:

| Sources                                       | Uses                             |
|---|----------------------------------|
| Proceeds from bonds sold, called or matured   | Purchase of bonds                |
| Proceeds from stocks sold                     | Purchase of stocks               |
| Proceeds from sale of unconsolidated investee | Acquisitions                     |
|   | Purchase of property & equipment |

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 December 31, 2014, our portfolio had a carrying value of \$2.0 billion. Portfolio assets at December 31, 2014, increased by \$42.2 million, or 2 percent, from December 31, 2013.

Our overall investment philosophy is designed to first protect policyholders by maintaining sufficient funds to meet corporate and policyholder obligations and then generate long-term growth in shareholders' equity. Because our existing and projected liabilities are sufficiently funded by the fixed income portfolio, we can improve returns by investing a portion of the surplus (within limits) in an equity portfolio. As of December 31, 2014, 49 percent of our shareholders' equity was invested in equities, compared to 51 percent at December 31, 2013 and 47 percent at December 31, 2012.

The fixed income portfolio is structured to meet policyholder obligations and optimize the generation of after-tax investment income and total return objectives.

FINANCING ACTIVITIES

In addition to the previously discussed operating and investing activities, we also engage in financing activities to manage our capital structure. The following list highlights some of the major sources and uses of cash flow from financing activities:

| Sources                                | Uses                  |
|--|-----------------------|
| Proceeds from stock offerings          | Shareholder dividends |
| Proceeds from debt offerings           | Debt repayment        |
| Short-term borrowing                   | Share buy-backs       |
| Shares issued under stock option plans |                       |

Our capital structure is comprised of equity and debt obligations. As of December 31, 2014, our capital structure consisted of \$149.6 million in 10-year maturity senior notes (long-term debt) and \$845.1 million of shareholders' equity. Debt outstanding comprised 15 percent of total capital as of December 31, 2014.

In December 2012, we filed a universal shelf registration statement with the SEC for the potential offering and sale of securities, including debt and equity securities. The shelf registration facilitated our \$150.0 million public debt offering completed in October 2013. The shelf registration will expire in December 2015.

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 December 31, 2014, our holding company had \$845.1 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 \$46.7 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

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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. In 2014, 2013 and 2012, our principal insurance subsidiary paid ordinary dividends totaling \$185.0 million, \$40.0 million and \$13.0 million, respectively, to RLI Corp. Any dividend distribution in excess of the ordinary dividend limits is deemed extraordinary and requires prior approval from the Illinois Department of Insurance. While no extraordinary dividends were paid in 2014 or 2013, our principal insurance subsidiary sought and received regulatory approval in 2012, prior to the payment of extraordinary dividends totaling \$125.0 million. As of December 31, 2014, \$53.4 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.

Our 155th consecutive dividend payment was declared in February 2015 and will be paid on March 20, 2015, in the amount of \$0.18 per share. Since the inception of cash dividends in 1976, we have increased our annual dividend every year.

## OUTLOOK FOR 2015

As we look ahead to 2015, our outlook has not changed significantly from 2014. The insurance market continues to be a very crowded space with increased pressure from new entrants and alternative capital. Top-line growth is difficult under these conditions, and we will continue to emphasize risk selection and underwriting profit over premium growth. The economic recovery has not been as robust as in previous cycles. While volatile commodity prices continue to impact our risk appetite in the energy segment, a moderate uptick in construction and increases in payroll and shipping has created new business opportunities and the potential for increased premium from our insureds. The lack of significant catastrophe activity continues to pressure rates on property business. We expect a stable to slightly softening rate environment on an overall portfolio basis.

Recent loss trends continued to be more muted than longer-term averages. We will focus on selective growth and controlling expenses without sacrificing service where we can in 2015. We will continue to look for additional underwriting talent and companies to acquire that fit our underwriting culture. We will remain a destination for rational underwriters and talented claim staff. We anticipate adding underwriters, additional classes or business units in niche segments of the insurance market. We expect our expansions in 2014, including healthcare liability, assumed E&S business, small programs and coverage enhancements to our package products, to have a larger impact on the top line over the long run. At the beginning of 2015, we renewed our major property and casualty reinsurance treaties, which resulted in savings of approximately \$7.0 million from improved reinsurance rates, while we expanded some coverages. This follows several years of improvements in terms and conditions. We expect a more stable reinsurance market through the remainder of 2015.

## CASUALTY

The casualty segment achieved growth in the professional liability and package products in 2014. These products were launched in 2009-2010 and we have expanded product offerings and classes of business since that time. We initially targeted design professionals and achieved good penetration within our targeted market. This growth has begun to moderate. Other professional classes and the related P&C coverages are expected to continue growing, as we only recently made these products available on a nationwide basis. The package business we purchased through CBIC grew in 2014, and we expect this trend to continue as we expand geographically and nurture those additional producer relationships. Our E&S casualty, transportation, medical professional and executive products coverages saw increased competition and flattening rates in 2014. We do not anticipate anything in the market to counteract that trend in 2015. In the fourth quarter, we expanded further into healthcare liability with a team focused on long-term care and hospital liability. Overall, we expect moderate growth in this segment in 2015.

While the market remains very competitive, we will continue to focus on risk selection. We expect pricing to remain flat across most of our casualty portfolio and loss trends to remain below long-term averages. Growth will be weighted toward specialty admitted lines, where expected underwriting margins are lower than in our E&S coverages. The change in mix will challenge our ability to maintain similar underwriting margins in 2015.

## PROPERTY

The property market is the most competitive of our three segments, due largely to the diversified catastrophe component within this segment. Alternative capital that continues to provide cheaper capacity to the (re)insurance community, particularly in Florida, has affected primary pricing. We experienced a decrease in exposure and premium in our difference in condition

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and earthquake portfolios during 2014. Our wind and fire business remained relatively flat. Based on market conditions, we do not expect growth in our E&S Property book. Our marine business has refocused on key classes and we expect measured, profitable growth in 2015. The recreational vehicles program, which was launched in 2012, experienced heightened loss activity in 2014. We implemented rate increases and expect a flat top line, as some insureds will choose to purchase coverage elsewhere. Finally, our crop reinsurance relationship will expire over the next year. In 2014, we recorded \$50.3 million and \$28.3 million of gross and net premium, respectively. With our cedant under new ownership, our participation has been greatly reduced. We will assume approximately \$10.0 million of gross and net premium in 2015. We expect this will be the last year of this assumed reinsurance agreement.

We added two small production sources in 2014 involving E&S homeowners and catastrophe coverage for builders' risk policies. Despite these new ventures and the recovery in marine, we do not expect to overcome the decrease in production from the crop business. Premium will likely decrease by more than 10 percent in the property segment in 2015. With the underwriting changes that have been implemented in our fire, marine and recreational vehicle business and the reduction in the underperforming crop business, we expect a slightly improved underwriting margin in 2015, barring significant catastrophe activity. Overall, we expect the property market to remain crowded and competitive in the year ahead.

## SURETY

The surety segment has grown materially over the last few years as we added underwriters in all business units: miscellaneous, commercial, energy and contract surety. In addition, we purchased CBIC in 2011, which expanded our footprint in the western states. The success in 2014 was largely driven by commercial surety where, despite increased competition, we were able to write additional bonds for current accounts and add some new accounts. Our energy-focused unit offset some of this growth, as they became very selective in light of challenging market conditions. Our underwriters required collateral or declined accounts where the company's financial status deteriorated as a result the reduction in energy prices. We also recognize global economic conditions could impact the U.S. economy and pressure contractors that have overextended their resources. We see these trends continuing into 2015, which will put pressure on energy and contract surety's top line. We continue to see new entrants to the market and competitors offering increased capacity. We expect a flat top line in 2015, but with our continued underwriting discipline, we would expect similar underwriting margins.

## INVESTMENTS

Capital markets and the U.S. macroeconomic environment were heavily influenced by external factors in 2014. The year began with a harsh winter landscape that put a significant strain on GDP potential and resulted in an outright contraction for the first quarter. Worldwide, a slower growth trajectory materialized for emerging markets and developed economies in Europe and Japan. By October, crude oil prices were in precipitous decline on incremental worldwide supply, which translated into lower gasoline costs by the fourth quarter. All of this accumulated in a low level of inflation and renewed monetary policy accommodation from global central banks. In the U.S., however,

domestic growth was strong enough by the second half of the year that the Federal Reserve suspended the extraordinary measures associated with quantitative easing. The Federal Open Market Committee, which sets the federal funds target interest rate, is in the early stages of normalizing U.S. monetary policy, the timing of which will remain data dependent but is expected to begin in mid-2015.

Sluggish global growth, a decline in European government bond yields and a preference for U.S. dollar assets increased the demand for long U.S. Treasuries, which limited the potential for yields to rise in 2014. The bellwether 10 year Treasury yield ended 2014 at 2.17 percent, down 0.86 percent from year end 2013. Uncertainty propelled enough market volatility by the fourth quarter that risk premiums rose for many fixed income asset classes. The most pronounced volatility was concentrated in securities related to the energy sector. Despite wider credit spreads, fixed income securities experienced price appreciation above expectations for the year on the decline in rates across the yield curve. Equities were a significant contributor as well, with the low rate environment boosting demand for stocks.

The United States remains one of the strongest world economies as we look forward, and we believe that our portfolio should be well positioned if growth continues to accelerate. The employment picture continues to be positive, although wage growth has been limited. And while lower gas prices should support the consumer, the strength of the U.S. dollar will be a headwind for multinational companies. Although capital markets may remain more volatile than the year ago period, the portfolio will continue to support operations through current income and contribute to long-term growth in book value via our low beta equity strategy. The near term yield environment will be challenging, and we expect little investment income growth over the next twelve months.

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PROSPECTIVE ACCOUNTING STANDARDS

Prospective accounting standards are those which we have not implemented either because the standard has not been finalized or the implementation date has not yet occurred. For a discussion of relevant prospective accounting standards, see note 1.D. to the consolidated financial statements within Item 8, Financial Statements and Supplementary Data.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

MARKET RISK DISCLOSURE

Market risk is a general term describing the potential economic loss associated with adverse changes in the fair value of financial instruments. Management of market risk is a critical component of our investment decisions and objectives. We manage our exposure to market risk by using the following tools:

- Monitoring the fair value of all financial assets on a constant basis,
- Changing the character of future investment purchases as needed and
- Maintaining a balance between existing asset and liability portfolios.

FIXED INCOME AND INTEREST RATE RISK

The most significant short-term influence on our fixed income portfolio is a change in interest rates. Because there is intrinsic difficulty predicting the direction and magnitude of interest rate moves, we attempt to minimize the impact of interest rate risk on the balance sheet by matching the duration of assets to that of our liabilities. Furthermore, the diversification of sectors and given issuers is core to our risk management process, increasing the granularity of individual credit risk. Liquidity and call risk are elements of fixed income that we regularly evaluate to ensure we are receiving adequate compensation. Our fixed income portfolio has a meaningful impact on financial results and is a key component in our enterprise risk simulations.

Interest rate risk can also affect our income statement due to its impact on interest expense. As of December 31, 2014 and 2013, we had no short-term debt obligations. We maintain a debt obligation that is long-term in nature and carries a fixed interest rate. As such, our interest expense on this obligation is not subject to changes in interest rates. As this debt is not due until 2023, we will not assume additional interest rate risk in our ability to refinance this debt for nearly ten years.



## EQUITY PRICE RISK

Equity price risk is the potential that we will incur economic loss due to the decline of common stock prices. Beta analysis is used to measure the sensitivity of our equity portfolio to changes in the value of the S&P 500 Index (an index representative of the broad equity market). Our current equity portfolio has a beta of 0.9 in comparison to the S&P 500 with a beta of 1.0. This lower beta statistic reflects our long-term emphasis on maintaining a value-oriented, dividend-driven investment philosophy for our equity portfolio.

## SENSITIVITY ANALYSIS

The tables that follow detail information on the market risk exposure for our financial investments as of December 31, 2014. Listed on each table is the December 31, 2014, fair value for our assets and the expected pretax reduction in fair value given the stated hypothetical events. This sensitivity analysis assumes the composition of our assets remains constant over the period being measured and also assumes interest rate changes are reflected uniformly across the yield curve. For example, our ability to hold non-trading securities to maturity mitigates price fluctuation risks. For purposes of this disclosure, market-risk-sensitive instruments are all classified as held for non-trading purposes, as we sold our remaining trading securities during 2013. The examples given are not predictions of future market events, but rather illustrations of the effect such events may have on the fair value of our investment portfolio.

As of December 31, 2014, our fixed income portfolio had a fair value of \$1.5 billion. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2014, levels with all other variables held constant. Such scenarios would result in decreases in the fair value of the fixed income portfolio of \$68.4 million and \$137.1 million, respectively.

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As of December 31, 2014, our equity portfolio had a fair value of \$410.6 million. The base sensitivity analysis uses market scenarios of the S&P 500 Index declining both 10 percent and 20 percent. These scenarios would result in approximate decreases in the equity fair value of \$35.9 million and \$71.8 million, respectively.

Counter to the base scenarios shown in Tables 1 and 2, Tables 3 and 4 quantify the opposite impact. Under the assumptions of falling interest rates and an increasing S&P 500 Index, the fair value of our assets will increase from their present levels by the indicated amounts.

TABLE 1

Effect of a 100-basis-point increase in interest rates and a 10 percent decline in the S&P 500:

| (in thousands)                 | 12/31/14<br>Fair<br>Value | Interest<br>Rate Risk | Equity<br>Risk |
|--------------------------------|---------------------------|-----------------------|----------------|
| Held for non-trading purposes: |                           |                       |                |
| Fixed income securities        | \$ 1,495,087              | \$ (68,368)           | \$ —           |
| Equity securities              | 410,642                   | —                     | (35,900)       |
| Total non-trading              | \$ 1,905,729              | \$ (68,368)           | \$ (35,900)    |

TABLE 2

Effect of a 200-basis-point increase in interest rates and a 20 percent decline in the S&P 500:

| (in thousands)                 | 12/31/14<br>Fair<br>Value | Interest<br>Rate Risk | Equity<br>Risk |
|--------------------------------|---------------------------|-----------------------|----------------|
| Held for non-trading purposes: |                           |                       |                |
| Fixed income securities        | \$ 1,495,087              | \$ (137,112)          | \$ —           |
| Equity securities              | 410,642                   | —                     | (71,799)       |
| Total non-trading              | \$ 1,905,729              | \$ (137,112)          | \$ (71,799)    |

TABLE 3

Effect of a 100-basis-point decrease in interest rates and a 10 percent increase in the S&P 500:

| (in thousands)                 | 12/31/14      | Interest<br>Rate Risk | Equity<br>Risk |
|--------------------------------|---------------|-----------------------|----------------|
|                                | Fair<br>Value |                       |                |
| Held for non-trading purposes: |               |                       |                |
| Fixed income securities        | \$ 1,495,087  | \$ 62,983             | \$ —           |
| Equity securities              | 410,642       | —                     | 35,900         |
| Total non-trading              | \$ 1,905,729  | \$ 62,983             | \$ 35,900      |

TABLE 4

Effect of a 200-basis-point decrease in interest rates and 20 percent increase in the S&P 500:

| (in thousands)                 | 12/31/14      | Interest<br>Rate Risk | Equity<br>Risk |
|--------------------------------|---------------|-----------------------|----------------|
|                                | Fair<br>Value |                       |                |
| Held for non-trading purposes: |               |                       |                |
| Fixed income securities        | \$ 1,495,087  | \$ 106,122            | \$ —           |
| Equity securities              | 410,642       | —                     | 71,799         |
| Total non-trading              | \$ 1,905,729  | \$ 106,122            | \$ 71,799      |

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Item 8. Financial Statements and Supplementary Data

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## Consolidated Balance Sheets

| (in thousands, except per share data)  | December 31, |              |
|--|--------------|--------------|
|  | 2014         | 2013         |
| Assets   |              |              |
| Investments and Cash:  |              |              |
| Fixed income:  |              |              |
| Available-for-sale, at fair value (amortized cost - \$1,448,204 in 2014 and \$1,431,049 in 2013)   | \$ 1,495,087 | \$ 1,440,052 |
| Held-to-maturity, at amortized cost (fair value - \$0 in 2014 and \$687 in 2013)   | —            | 651          |
| Equity securities available-for-sale, at fair value (cost - \$193,535 in 2014 and \$218,848 in 2013)   | 410,642      | 418,654      |
| Short-term investments, at cost which approximates fair value  | 16,339       | 23,232       |
| Other invested assets  | 11,597       | —            |
| Cash   | 30,620       | 39,469       |
| Total investments and cash   | \$ 1,964,285 | \$ 1,922,058 |
| Accrued investment income  | \$ 14,629    | \$ 15,710    |
| Premiums and reinsurance balances receivable, net of allowances for uncollectible amounts of \$14,245 in 2014 and \$13,328 in 2013   | 154,573      | 152,509      |
| Ceded unearned premiums  | 53,961       | 60,407       |
| Reinsurance balances recoverable on unpaid losses and settlement expenses, net of allowances for uncollectible amounts of \$13,049 in 2014 and \$14,239 in 2013                                      | 335,106      | 354,924      |
| Deferred policy acquisition costs, net   | 65,123       | 61,508       |
| Property and equipment, at cost, net of accumulated depreciation of \$34,365 in 2014 and \$41,491 in 2013  | 42,549       | 40,261       |
| Investment in unconsolidated investees   | 60,046       | 49,793       |
| Goodwill and intangibles   | 72,695       | 74,876       |
| Other assets   | 12,575       | 8,264        |
| Total assets   | \$ 2,775,542 | \$ 2,740,310 |
| Liabilities and Shareholders' Equity   |              |              |
| Liabilities:   |              |              |
| Unpaid losses and settlement expenses  | \$ 1,121,040 | \$ 1,129,433 |
| Unearned premiums  | 401,412      | 392,081      |
| Reinsurance balances payable   | 38,013       | 47,334       |
| Funds held   | 51,481       | 61,656       |
| Income taxes - deferred  | 82,285       | 57,801       |
| Bonds payable, long-term debt  | 149,625      | 149,582      |
| Accrued expenses   | 63,148       | 59,596       |
| Other liabilities  | 23,476       | 13,861       |
| Total liabilities  | \$ 1,930,480 | \$ 1,911,344 |
| Shareholders' equity:  |              |              |
| Common stock (\$1 par value, authorized 100,000,000 shares, issued 66,032,929 shares in 2014 and 65,912,638 shares in 2013, and outstanding 43,102,715 shares in 2014 and 42,982,424 shares in 2013) | \$ 66,033    | \$ 65,913    |

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|  |              |              |
|--|--------------|--------------|
| Paid in capital  | 213,737      | 208,705      |
| Accumulated other comprehensive earnings, net of tax         | 171,383      | 136,027      |
| Retained earnings  | 786,908      | 811,320      |
| Deferred compensation  | 13,769       | 11,562       |
| Treasury stock, at cost (22,930,214 shares in 2014 and 2013) | (406,768)    | (404,561)    |
| Total shareholders' equity                                   | \$ 845,062   | \$ 828,966   |
| Total liabilities and shareholders' equity                   | \$ 2,775,542 | \$ 2,740,310 |

See accompanying notes to consolidated financial statements.

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## Consolidated Statements of Earnings and Comprehensive Earnings

| (in thousands, except per share data)                 | Years ended December 31, |            |            |
|---|--------------------------|------------|------------|
|   | 2014                     | 2013       | 2012       |
| Net premiums earned                                   | \$ 687,375               | \$ 630,802 | \$ 576,571 |
| Net investment income                                 | 55,608                   | 52,763     | 58,831     |
| Net realized investment gains                         | 32,182                   | 22,036     | 26,528     |
| Other-than-temporary-impairment losses on investments | —                        | —          | (1,156)    |
| Consolidated revenue                                  | \$ 775,165               | \$ 705,601 | \$ 660,774 |
| Losses and settlement expenses                        | \$ 296,609               | \$ 259,801 | \$ 271,645 |
| Policy acquisition costs                              | 229,283                  | 210,651    | 196,362    |
| Insurance operating expenses                          | 54,464                   | 53,557     | 44,971     |
| Interest expense on debt                              | 7,438                    | 8,095      | 6,050      |
| General corporate expenses                            | 10,222                   | 8,746      | 7,867      |
| Total expenses  | \$ 598,016               | \$ 540,850 | \$ 526,895 |
| Equity in earnings of unconsolidated investees        | 12,338                   | 10,915     | 8,853      |
| Earnings before income taxes                          | \$ 189,487               | \$ 175,666 | \$ 142,732 |
| Income tax expense:                                   |                          |            |            |
| Current   | \$ 48,596                | \$ 43,346  | \$ 35,605  |
| Deferred  | 5,446                    | 6,065      | 3,781      |
| Income tax expense:                                   | \$ 54,042                | \$ 49,411  | \$ 39,386  |
| Net earnings  | \$ 135,445               | \$ 126,255 | \$ 103,346 |
| Other comprehensive earnings (loss), net of tax       | 35,356                   | (7,143)    | 25,845     |
| Comprehensive earnings                                | \$ 170,801               | \$ 119,112 | \$ 129,191 |
| Basic:  |                          |            |            |
| Net earnings per share                                | \$ 3.15                  | \$ 2.95    | \$ 2.44    |
| Comprehensive earnings per share                      | \$ 3.97                  | \$ 2.79    | \$ 3.04    |
| Diluted:  |                          |            |            |
| Net earnings per share                                | \$ 3.09                  | \$ 2.90    | \$ 2.39    |
| Comprehensive earnings per share                      | \$ 3.90                  | \$ 2.74    | \$ 2.99    |
| Weighted average number of common shares outstanding  |                          |            |            |
| Basic   | 43,020                   | 42,744     | 42,431     |
| Diluted   | 43,819                   | 43,514     | 43,160     |

See accompanying notes to consolidated financial statements.





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## Consolidated Statements of Shareholders' Equity

| (in thousands,<br>except per<br>share data)            | Common<br>Shares | Total<br>Shareholders'<br>Equity | Common<br>Stock | Paid-in<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Earnings (Loss) | Retained<br>Earnings | Deferred<br>Compensation | Treasury Stock<br>Cost |
|--|------------------|----------------------------------|-----------------|--------------------|--|----------------------|--------------------------|------------------------|
| Balance,<br>January 1, 2012                            | 42,324,274       | \$ 792,634                       | \$ 65,254       | \$ 195,161         | \$ 117,325   | \$ 807,893           | \$ 10,445                | \$ (403,444)           |
| Net earnings   | —                | \$ 103,346                       | \$ —            | \$ —               | \$ —   | \$ 103,346           | \$ —                     | \$ —                   |
| Other<br>comprehensive<br>earnings, net of<br>tax      | —                | 25,845                           | —               | —                  | 25,845   | —                    | —                        | —                      |
| Deferred<br>compensation<br>under Rabbi<br>trust plans | —                | —                                | —               | —                  | —  | —                    | 661                      | (661)                  |
| Stock option<br>excess tax<br>benefit                  | —                | 1,471                            | —               | 1,471              | —  | —                    | —                        | —                      |
| Exercise of<br>stock options                           | 200,974          | 6,104                            | 201             | 5,903              | —  | —                    | —                        | —                      |
| Dividends paid<br>(\$3.13 per<br>share)                | —                | (133,037)                        | —               | —                  | —  | (133,037)            | —                        | —                      |
| Balance,<br>December 31,<br>2012                       | 42,525,248       | \$ 796,363                       | \$ 65,455       | \$ 202,535         | \$ 143,170   | \$ 778,202           | \$ 11,106                | \$ (404,105)           |
| Net earnings   | —                | \$ 126,255                       | \$ —            | \$ —               | \$ —   | \$ 126,255           | \$ —                     | \$ —                   |
| Other<br>comprehensive<br>earnings, net of<br>tax      | —                | (7,143)                          | —               | —                  | (7,143)  | —                    | —                        | —                      |
| Deferred<br>compensation<br>under Rabbi<br>trust plans | —                | —                                | —               | —                  | —  | —                    | 456                      | (456)                  |
| Stock option<br>excess tax<br>benefit                  | —                | 6,310                            | —               | 6,310              | —  | —                    | —                        | —                      |
| Exercise of<br>stock options                           | 457,176          | 318                              | 458             | (140)              | —  | —                    | —                        | —                      |

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|  |            |            |           |            |            |            |           |              |
|--|------------|------------|-----------|------------|------------|------------|-----------|--------------|
| Dividends paid<br>(\$2.17 per<br>share)                | —          | (93,137)   | —         | —          | —          | (93,137)   | —         | —            |
| Balance,<br>December 31,<br>2013                       | 42,982,424 | \$ 828,966 | \$ 65,913 | \$ 208,705 | \$ 136,027 | \$ 811,320 | \$ 11,562 | \$ (404,561) |
| Net earnings   | —          | \$ 135,445 | \$ —      | \$ —       | \$ —       | \$ 135,445 | \$ —      | \$ —         |
| Other<br>comprehensive<br>earnings, net of<br>tax      | —          | 35,356     | —         | —          | 35,356     | —          | —         | —            |
| Deferred<br>compensation<br>under Rabbi<br>trust plans | —          | —          | —         | —          | —          | —          | 2,207     | (2,207)      |
| Stock option<br>excess tax<br>benefit                  | —          | 1,766      | —         | 1,766      | —          | —          | —         | —            |
| Exercise of<br>stock options                           | 120,291    | 3,386      | 120       | 3,266      | —          | —          | —         | —            |
| Dividends paid<br>(\$3.71 per<br>share)                | —          | (159,857)  | —         | —          | —          | (159,857)  | —         | —            |
| Balance,<br>December 31,<br>2014                       | 43,102,715 | \$ 845,062 | \$ 66,033 | \$ 213,737 | \$ 171,383 | \$ 786,908 | \$ 13,769 | \$ (406,768) |

See accompanying notes to consolidated financial statements.

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## Consolidated Statements of Cash Flows

| (in thousands)   | 2014       | 2013       | 2012        |
|--|------------|------------|-------------|
| Cash flows from operating activities:  |            |            |             |
| Net earnings   | \$ 135,445 | \$ 126,255 | \$ 103,346  |
| Adjustments to reconcile net earnings to net cash provided by operating activities       |            |            |             |
| Net realized investment gains  | (32,182)   | (22,036)   | (25,372)    |
| Depreciation   | 4,557      | 3,765      | 3,145       |
| Other items, net   | 10,818     | 13,104     | 7,732       |
| Change in:   |            |            |             |
| Accrued investment income  | 1,081      | (1,307)    | (538)       |
| Premiums and reinsurance balances receivable (net of direct write-offs and commutations) | (2,064)    | (13,154)   | (14,859)    |
| Reinsurance balances payable   | (9,321)    | 3,375      | (6,902)     |
| Funds held   | (10,175)   | 5,023      | (53,922)    |
| Ceded unearned premium   | 6,446      | 12,785     | (11,563)    |
| Reinsurance balances recoverable on unpaid losses  | 19,818     | 4,960      | (6,079)     |
| Deferred policy acquisition costs  | (3,615)    | (9,164)    | (239)       |
| Accrued expenses   | 3,552      | 9,663      | (8,950)     |
| Unpaid losses and settlement expenses  | (8,393)    | (29,050)   | 7,769       |
| Unearned premiums  | 9,331      | 22,735     | 28,079      |
| Income taxes   |            |            |             |
| Current  | (155)      | 5,966      | 14,536      |
| Deferred   | 5,446      | 6,065      | 3,781       |
| Stock option excess tax benefit  | (1,766)    | (6,310)    | (1,471)     |
| Changes in investment in unconsolidated investees:                                       |            |            |             |
| Undistributed earnings   | (12,338)   | (10,915)   | (8,853)     |
| Dividends received   | 6,600      | 13,200     | 6,600       |
| Net proceeds from trading portfolio activity   | —          | 6          | —           |
| Net cash provided by operating activities  | \$ 123,085 | \$ 134,966 | \$ 36,240   |
| Cash flows from investing activities:  |            |            |             |
| Purchase of:   |            |            |             |
| Fixed income, held-to-maturity   | \$ —       | \$ —       | \$ (25,078) |
| Fixed income, available-for-sale   | (470,210)  | (545,899)  | (632,955)   |
| Equity securities, available-for-sale  | (18,088)   | (31,010)   | (34,113)    |
| Short-term investments, net  | —          | —          | (6,597)     |
| Property and equipment   | (7,121)    | (17,531)   | (15,292)    |
| Acquisition of Rockbridge Underwriting Agency  | —          | —          | (15,500)    |
| Investment in equity method investee   | (5,301)    | —          | —           |

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|   |              |              |              |
|---|--------------|--------------|--------------|
| Other   | (5,534)      | —            | (400)        |
| Proceeds from sale of:                              |              |              |              |
| Fixed income, held-to-maturity                      | 654          | —            | —            |
| Fixed income, available-for-sale                    | 342,308      | 173,694      | 181,338      |
| Equity securities, available-for-sale               | 72,869       | 73,982       | 78,315       |
| Short-term investments, net                         | 11,401       | 7,230        | —            |
| Property and equipment                              | 276          | 1,492        | 684          |
| Other   | —            | 400          | —            |
| Proceeds from call or maturity of:                  |              |              |              |
| Fixed income, held-to-maturity                      | —            | 11,090       | 273,816      |
| Fixed income, available-for-sale                    | 101,517      | 224,620      | 248,134      |
| Net cash provided by (used in) investing activities | \$ 22,771    | \$ (101,932) | \$ 52,352    |
| Cash flows from financing activities:               |              |              |              |
| Stock option excess tax benefit                     | \$ 1,766     | \$ 6,310     | \$ 1,471     |
| Proceeds from stock option exercises                | 3,386        | 318          | 6,104        |
| Proceeds from issuance of senior notes              | —            | 149,571      | —            |
| Payment on senior notes                             | —            | (99,504)     | —            |
| Debt issue costs paid                               | —            | (1,437)      | —            |
| Cash dividends paid                                 | (159,857)    | (93,137)     | (133,037)    |
| Net cash used in financing activities               | \$ (154,705) | \$ (37,879)  | \$ (125,462) |
| Net decrease in cash                                | \$ (8,849)   | \$ (4,845)   | \$ (36,870)  |
| Cash at beginning of year                           | \$ 39,469    | \$ 44,314    | \$ 81,184    |
| Cash at end of year                                 | \$ 30,620    | \$ 39,469    | \$ 44,314    |

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Notes to Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A.DESCRPTION OF BUSINESS

We underwrite selected property and casualty insurance coverages. 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, a subsidiary of RLI Ins., writes surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company (RIC), a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines of insurance on an admitted basis in 48 states and the District of Columbia. 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.

B.PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

The accompanying consolidated financial statements were prepared in conformity with generally accepted accounting principles in the United States of America (GAAP), which differ in some respects from those followed in reports to insurance regulatory authorities. The consolidated financial statements include the accounts of our holding company and our subsidiaries. All significant intercompany balances and transactions have been eliminated. Certain reclassifications were made to 2013 and 2012 to conform to the classifications used in the current year.

C.ADOPTED ACCOUNTING STANDARDS

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

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

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

#### D. PROSPECTIVE ACCOUNTING STANDARDS

There are no prospective accounting standards which would have a material impact on our financial statements as of December 31, 2014.

#### E. INVESTMENTS:

We classify our investments in all debt and equity securities into one of three categories: available-for-sale, held-to-maturity or trading.

#### AVAILABLE-FOR-SALE SECURITIES

Debt and equity securities not included as held-to-maturity are classified as available-for-sale and reported at fair value. Unrealized gains and losses on these securities are excluded from net earnings but are recorded as a separate component of comprehensive earnings and shareholders' equity, net of deferred income taxes. All of our debt and equity securities are classified as available-for-sale.

#### HELD-TO-MATURITY SECURITIES

Debt securities that we have the positive intent and ability to hold to maturity are classified as held-to-maturity and carried at amortized cost. Except for declines that are other-than-temporary, changes in the fair value of these securities are not

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reflected in the financial statements. During the fourth quarter we sold our remaining debt security classified as held-to-maturity. This security was to mature on February 1, 2015.

TRADING SECURITIES

Debt and equity securities purchased for short-term resale are classified as trading securities. These securities are reported at fair value with unrealized gains and losses included in earnings. During 2013, we sold our remaining debt securities classified as trading.

For the years ended December 31, 2014, 2013 and 2012, no securities were transferred from held-to-maturity to available-for-sale or trading.

OTHER THAN TEMPORARY IMPAIRMENT

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

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

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

quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates. See note 2 for further discussion of OTTI.

Interest on fixed maturities and short-term investments is credited to earnings on an accrual basis. Premiums and discounts are amortized or accreted over the lives of the related fixed maturities. Dividends on equity securities are credited to earnings on the ex-dividend date. Realized gains and losses on disposition of investments are based on specific identification of the investments sold on the settlement date.

#### F.CASH, SHORT-TERM INVESTMENTS AND OTHER INVESTED ASSETS

Cash consists of uninvested balances in bank accounts. Short-term investments consist of investments with original maturities of 90 days or less, primarily AAA-rated prime and government money market funds. Short-term investments are carried at cost, which approximates fair value. We have not experienced losses on these instruments. Other invested assets includes an investment in a low income housing tax credit partnership, carried at amortized cost, and membership in the Federal Home Loan Bank Chicago, carried at cost.

#### G.REINSURANCE

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not relieve us of our legal liability to our policyholders.



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We continuously monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements, quarterly disclosures and Securities and Exchange Commission (SEC) filings for those reinsurers that are publicly traded. We also review insurance industry developments that may impact the financial condition of our reinsurers. We analyze the credit risk associated with our reinsurance balances recoverable by monitoring the A.M. Best and Standard & Poor's (S&P) ratings of our reinsurers. In addition, we subject our reinsurance recoverables to detailed recoverable tests, including one based on average default by S&P rating. Based upon our review and testing, our policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that we may be unable to recover.

## H.POLICY ACQUISITION COSTS

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

## I.PROPERTY AND EQUIPMENT

Property and equipment are presented at cost less accumulated depreciation and are depreciated on a straight-line basis for financial statement purposes over periods ranging from 3 to 10 years for equipment and up to 30 years for buildings and improvements.

## J.INVESTMENT IN UNCONSOLIDATED INVESTEEES

We maintain a 40 percent interest in the earnings of Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality polarized sunglasses, which is accounted for by the equity method. We also maintain a similar minority representation on their board of directors. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim. We carry this investment at the holding company, RLI Corp., level as it is not core to our insurance operations. Our investment in Maui Jim was \$54.3 million in 2014 and \$49.8 million in 2013. In 2014, we recorded \$12.0 million in investee earnings for Maui Jim, compared to \$10.9 million in 2013 and \$8.9 million in 2012. Maui

Jim recorded net income of \$30.7 million in 2014, \$26.1 million in 2013 and \$22.6 million in 2012. Additional summarized financial information for Maui Jim for 2014 and 2013 is outlined in the following table:

| (in millions)     | 2014     | 2013     |
|-------------------|----------|----------|
| Total assets      | \$ 219.8 | \$ 193.5 |
| Total liabilities | 107.6    | 92.7     |
| Total equity      | 112.2    | 100.8    |

Approximately \$42.1 million of undistributed earnings from Maui Jim are included in our retained earnings as of December 31, 2014. In 2014, 2013 and 2012, we received dividends of \$6.6 million, \$13.2 million and \$6.6 million, respectively, from Maui Jim.

On February 5, 2014, we invested \$5.3 million for a 20 percent equity ownership interest in Prime Holdings Insurance Services, Inc. (Prime), an Illinois domiciled insurance carrier based in Salt Lake City, Utah. Prime is a privately-held excess and surplus lines insurance company that distributes its products through a network of wholesale brokers and specializes in hard-to-place risks. Our investment in Prime was \$5.7 million at December 31, 2014 and we recorded \$0.3 million in investee earnings during the year. Additionally, we entered into a 25 percent quota share reinsurance treaty with Prime, effective January 1, 2014, which contributed \$10.2 million of gross premiums written and \$5.3 million of net premiums earned during the year.

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We perform annual impairment reviews of our investments in our unconsolidated investees, which considers current valuation and operating results. Based upon the most recent reviews, the assets were not impaired.

K.INTANGIBLE ASSETS

In accordance with GAAP guidelines, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill and intangibles totaled \$72.7 million at December 31, 2014. These assets relate to acquisition activity including our recent acquisitions of CBIC and Rockbridge Underwriting Agency (Rockbridge).

Goodwill and intangibles 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 CBIC acquisition in April 2011 totaled \$30.6 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 in the second quarter of 2014. Based upon these reviews, none of the assets were impaired. However, a fair value amount for state insurance licenses was obtained during the fourth quarter from a merger and acquisition broker with expertise in providing valuations for fully-licensed P&C shell companies, triggering the need for an interim impairment analysis of CBIC's licenses. The carrying cost of CBIC's licenses exceeded the fair value and resulted in a \$1.3 million impairment included as a net realized investment loss in the consolidated statement of earnings. There were no other triggering events that occurred as of December 31, 2014 that would suggest an updated review was necessary. Definite-lived intangible assets related to the CBIC acquisition totaled \$2.7 million, net of amortization, as of December 31, 2014.

The remaining \$15.9 million of goodwill and intangibles relates to our purchase of Rockbridge in November 2012. Of this amount, \$12.4 million is recorded as goodwill attributable to our casualty segment. The remaining \$3.5 million relates to definite-lived intangible assets, net of amortization, as of December 31, 2014. Annual impairment testing was performed on this goodwill in the fourth quarter of 2014. Based upon this review, the asset was not impaired. In addition, as of December 31, 2014, there were no triggering events that occurred that would suggest an updated review was necessary.

The aforementioned definite-lived intangible assets are amortized against future operating results based on their estimated useful lives. Amortization of intangible assets resulting from the acquisitions of CBIC and Rockbridge was \$0.9 million, \$1.2 million and \$1.0 million for 2014, 2013 and 2012, respectively.

#### L.UNPAID LOSSES AND SETTLEMENT EXPENSES

The liability for unpaid losses and settlement expenses represents estimates of amounts needed to pay reported and unreported claims and related expenses. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. Due to the inherent uncertainty in estimating reserves for losses and settlement expenses, there can be no assurance that the ultimate liability will not exceed recorded amounts. If actual liabilities do exceed recorded amounts, there will be an adverse effect. Furthermore, we may determine that recorded reserves are more than adequate to cover expected losses, as happened during 2010 through 2014, when favorable experience primarily on casualty business led us to reduce our reserves. Based on the current assumptions used in estimating reserves, we believe that our overall reserve levels at December 31, 2014, make a reasonable provision to meet our future obligations. See note 6 for a further discussion of unpaid losses and settlement expenses.

#### M.INSURANCE REVENUE RECOGNITION

Insurance premiums are recognized ratably over the term of the contracts, net of ceded reinsurance. Unearned premiums are calculated on a monthly pro rata basis.

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N.INCOME TAXES

We file a consolidated federal income tax return. Federal income taxes are accounted for using the asset and liability method under which deferred income taxes are recognized for the tax consequences of “temporary differences” by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities, operating losses and tax credit carry forwards. The effect on deferred taxes for a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance if it is more likely than not all or some of the deferred tax assets will not be realized.

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

During 2013, the Internal Revenue Service (IRS) completed an examination of the income tax returns for the years 2010 and 2011, which produced no material change to net earnings. Although 2011 has been examined by the IRS, tax years 2011 through 2014 remain open and are subject to examination or re-examination.

As an insurance company, we are subject to minimal state income tax liabilities. On a state basis, since the majority of our income is from insurance operations, we pay premium tax in lieu of state income tax. Premium taxes are a component of policy acquisition costs and calculated as a percentage of gross premiums written.

O.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 consolidated financial statements.

| (in thousands, except per share data)                           | Income<br>(Numerator) | Weighted Average<br>Shares<br>(Denominator) | Per Share<br>Amount |
|---|-----------------------|---|---------------------|
| For the year ended December 31, 2014                            |                       |   |                     |
| Basic EPS   |                       |   |                     |
| Income available to common shareholders                         | \$ 135,445            | 43,020                                      | \$ 3.15             |
| Stock options   | —                     | 799   |                     |
| Diluted EPS   |                       |   |                     |
| Income available to common shareholders and assumed conversions | \$ 135,445            | 43,819                                      | \$ 3.09             |
| For the year ended December 31, 2013                            |                       |   |                     |
| Basic EPS   |                       |   |                     |
| Income available to common shareholders                         | \$ 126,255            | 42,744                                      | \$ 2.95             |
| Stock options   | —                     | 770   |                     |
| Diluted EPS   |                       |   |                     |
| Income available to common shareholders and assumed conversions | \$ 126,255            | 43,514                                      | \$ 2.90             |
| For the year ended December 31, 2012                            |                       |   |                     |
| Basic EPS   |                       |   |                     |
| Income available to common shareholders                         | \$ 103,346            | 42,431                                      | \$ 2.44             |
| Stock options   | —                     | 729   |                     |
| Diluted EPS   |                       |   |                     |
| Income available to common shareholders and assumed conversions | \$ 103,346            | 43,160                                      | \$ 2.39             |

## P.COMPREHENSIVE EARNINGS

Our comprehensive earnings include net earnings plus unrealized gains/losses on our available-for-sale investment securities, net of tax. In reporting the components of comprehensive earnings on a net basis in the statement of earnings, we used a 35 percent tax rate. Other comprehensive income (loss), as shown in the consolidated statements of earnings and comprehensive earnings, is net of tax expense (benefit) of \$19.0 million, \$(3.8) million and \$13.9 million for 2014, 2013 and 2012, respectively.

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

| Unrealized Gains/Losses on Available-for-Sale Securities<br>(in thousands) | For the Year Ended December 31, |            |            |
|--|---------------------------------|------------|------------|
|  | 2014                            | 2013       | 2012       |
| Beginning balance  | \$ 136,027                      | \$ 143,170 | \$ 117,325 |
| Other comprehensive earnings before reclassifications                      | 57,081                          | 7,723      | 44,079     |
| Amounts reclassified from accumulated other comprehensive earnings         | (21,725)                        | (14,866)   | (18,234)   |
| Net current-period other comprehensive earnings (loss)                     | \$ 35,356                       | \$ (7,143) | \$ 25,845  |
| Ending balance   | \$ 171,383                      | \$ 136,027 | \$ 143,170 |



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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.

Amount Reclassified from Accumulated Other Comprehensive Earnings  
(in thousands)

| Component of Accumulated<br>Other Comprehensive Earnings        | For the Year Ended December 31, |           |           | Affected line item in the<br>Statement of Earnings              |
|---|---------------------------------|-----------|-----------|---|
|   | 2014                            | 2013      | 2012      |   |
| Unrealized gains and losses on<br>available-for-sale securities | \$ 33,423                       | \$ 22,871 | \$ 29,209 | Net realized investment gains                                   |
|   | —                               | —         | (1,156)   | Other-than-temporary impairment<br>(OTTI) losses on investments |
|   | 33,423                          | 22,871    | 28,053    | Earnings before income taxes                                    |
|   | (11,698)                        | (8,005)   | (9,819)   | Income tax expense  |
|   | \$ 21,725                       | \$ 14,866 | \$ 18,234 | Net earnings  |

#### Q.FAIR VALUE DISCLOSURES

Fair value is defined as the price in the principal market that would be received for an asset to facilitate an orderly transaction between market participants on the measurement date. We determined the fair value of certain financial instruments based on their underlying characteristics and relevant transactions in the marketplace. GAAP guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value.

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

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

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

Mortgage-backed Securities (MBS)/Collateralized Mortgage Obligations (CMO) 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, pre-payment assumptions and to incorporate collateral performance. To evaluate CMO volatility, an option adjusted spread model is used in combination with models that simulate interest rate paths to determine market price

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information. This process allows the pricing vendor to obtain evaluations of a broad universe of securities in a way that reflects changes in yield curve, index rates, implied volatility, mortgage rates and recent trade activity. MBS/CMO and ABS with corroborated, observable inputs are classified as Level 2. All of our MBS/CMO 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 service. Our review consists of a two-pronged approach. First, we compare prices provided by our pricing service to those provided by an additional source. Second, we obtain prices from securities brokers and compare them to the prices provided by our pricing service. 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 service are reasonable.

For common stock, we receive prices from the same 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. The fair value of our long-term debt is discussed further in note 4. See note 13 for fair value of assets and liabilities acquired with Rockbridge.

R.STOCK-BASED COMPENSATION

We expense the estimated fair value of employee stock options and similar awards. Guidance requires entities to measure compensation cost for awards of equity instruments to employees based on the grant-date fair value of those awards and recognize compensation expense over the service period that the awards are expected to vest.

We calculate the tax effects of share-based compensation under the alternative transition method as permitted by GAAP guidance. The alternative transition method includes simplified methods to determine the impact on the additional paid-in capital pool and consolidated statements of cash flows of the tax effects of employee share-based compensation awards.

See note 8 for further discussion and related disclosures regarding stock options.

## S.RISKS AND UNCERTAINTIES:

Certain risks and uncertainties are inherent to our day-to-day operations and to the process of preparing our consolidated financial statements. The more significant risks and uncertainties, as well as our attempt to mitigate, quantify and minimize such risks, are presented below and throughout the notes to the consolidated financial statements.

### Catastrophe Exposures

Our insurance coverages include exposure to catastrophic events. We monitor all catastrophe exposures by quantifying our exposed policy limits in each region and by using computer-assisted modeling techniques. Additionally, we limit our risk to such catastrophes through restraining the total policy limits written in each region and by purchasing reinsurance. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. In 2014, for this coverage, we had protection of \$300 million in excess of \$25 million first-dollar retention for earthquakes in California and \$325 million in excess of a \$25 million first-dollar retention for earthquakes outside of California. These amounts are subject to certain co-participations by us on losses in excess of the \$25 million retentions. Our second largest catastrophe exposure is to losses caused by wind storms to commercial properties throughout the Gulf and East Coasts, as well as to homes we insure in Hawaii. In 2014, these coverages were supported by \$225 million in excess of a \$25 million first-dollar retention in traditional catastrophe reinsurance protection, subject to certain retentions by us in the excess layers. In addition, we have incidental exposure to international catastrophic events.

Our catastrophe reinsurance treaty renewed on January 1, 2015. We purchased the same limits over the same first-dollar retention amounts outlined above, subject to certain retentions by us in the excess layers. We actively manage our catastrophe program to keep our net retention in line with risk tolerances and to optimize the risk/return trade off.

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### Environmental Exposures

We are subject to environmental claims and exposures primarily through our commercial umbrella, general liability and discontinued assumed casualty reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, we seek to mitigate or control the extent of this exposure on the vast majority of this business through the following methods: (1) our policies include pollution exclusions that have been continually updated to further strengthen them, (2) our policies primarily cover moderate hazard risks and (3) we began writing this business after the insurance industry became aware of the potential pollution liability exposure and implemented changes to limit its exposure to this hazard.

In 2009, as an extension of our excess and surplus lines general liability product, we expanded our offerings into low to moderate environmental liability exposures for small contractors and asbestos and mold remediation specialists. The business unit also provides limited coverage for individually underwritten underground storage tanks. We attempted to mitigate the overall exposure by focusing on smaller risks with low to moderate exposures. A large portion of this business is also offered on a claims-made basis with relatively low limits. We avoid risks that have large-scale exposures including petrochemical, chemical, mining, manufacturers and other risks that might be exposed to superfund sites. This business is covered under our casualty ceded reinsurance treaties. Since 2009, we have written a total of \$13.0 million of premium from this new product extension with \$3.7 million written in 2014.

We made loss and settlement expense payments on environmental liability claims and have loss and settlement expense reserves for others. We include this historical environmental loss experience with the remaining loss experience in the applicable line of business to project ultimate incurred losses and settlement expenses as well as related incurred but not reported (IBNR) loss and settlement expense reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, we used this experience to record loss and settlement expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 6.

### Reinsurance

Reinsurance does not discharge us from our primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, we would be liable. We continuously monitor the financial condition of prospective and existing reinsurers. As a result, we purchase reinsurance from a number of financially strong reinsurers. We provide an allowance for reinsurance balances deemed uncollectible. See further discussion of reinsurance exposures in note 5.

## Investment Risk

Our investment portfolio is subject to market, credit and interest rate risks. The equity portfolio will fluctuate with movements in the overall stock market. While the equity portfolio has been constructed to have lower downside risk than the market, the portfolio is sensitive to movements in the market. The bond portfolio is affected by interest rate changes and movement in credit spreads. We attempt to mitigate our interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities with varied maturities. Downturns in the financial markets could have a negative effect on our portfolio. However, we attempt to manage this risk through asset allocation, duration and security selection.

## Liquidity Risk

Liquidity is essential to our business and a key component of our concept of asset-liability matching. Our liquidity may be impaired by an inability to collect premium receivable or reinsurance recoverable balances in a timely manner, an inability to sell assets or redeem our investments, an inability to access funds from our insurance subsidiaries, unforeseen outflows of cash or large claim payments or an inability to access debt or equity capital markets. This situation may arise due to circumstances that we may be unable to control, such as a general market disruption, an operational problem that affects third parties or us, or even by the perception among market participants that we, or other market participants, are experiencing greater liquidity risk.

Our credit ratings are important to our liquidity. A reduction in our credit ratings could adversely affect our liquidity and competitive position, by increasing our borrowing costs or limiting our access to the capital markets.

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### Financial Statements

The preparation of the accompanying consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions about future events. These estimates and the underlying assumptions affect the amounts of assets and liabilities reported, disclosures about contingent assets and liabilities and reported amounts of revenues and expenses. The most significant of these amounts is the liability for unpaid losses and settlement expenses. Other estimates include investment valuation and OTTIs, the collectability of reinsurance balances, recoverability of deferred tax assets and deferred policy acquisition costs. These estimates and assumptions are based on management's best estimates and judgment. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, which management believes to be reasonable under the circumstances. We adjust such estimates and assumptions when facts and circumstances dictate. Although recorded estimates are supported by actuarial computations and other supportive data, the estimates are ultimately based on our expectations of future events. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in those estimates resulting from continuing changes in the economic environment will be reflected in the consolidated financial statements in future periods.

### External Factors

Our insurance subsidiaries are highly regulated by the state in which they are incorporated and by the states in which they do business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments and regulate rates insurers may charge for various coverages. We are also subject to insolvency and guarantee fund assessments for various programs designed to ensure policyholder indemnification. We generally accrue an assessment during the period in which it becomes probable that a liability has been incurred from an insolvency and the amount of the related assessment can be reasonably estimated.

The National Association of Insurance Commissioners (NAIC) has developed Property/Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written and unearned premium) risk. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. We regularly monitor our subsidiaries' internal capital requirements and the NAIC's RBC developments. As of December 31, 2014, we determined that our capital levels are well in excess of the minimum capital requirements for all RBC action levels and that our capital levels are sufficient to support the level of risk inherent in our operations. See note 9 for further discussion of statutory information and related insurance regulatory restrictions.

In addition, ratings are a critical factor in establishing the competitive position of insurance companies. Our insurance companies are rated by A.M. Best, S&P and Moody's. Their ratings reflect their opinions of an insurance company's

and an insurance holding company's, financial strength, operating performance, strategic position and ability to meet its obligations to policyholders.

## 2. INVESTMENTS

A summary of net investment income is as follows:

| NET INVESTMENT INCOME<br>(in thousands)     | 2014      | 2013      | 2012      |
|---|-----------|-----------|-----------|
| Interest on fixed income securities         | \$ 48,757 | \$ 45,870 | \$ 50,646 |
| Dividends on equity securities              | 11,962    | 11,865    | 12,848    |
| Interest on cash and short-term investments | 7         | 23        | 15        |
| Gross investment income                     | 60,726    | 57,758    | 63,509    |
| Less investment expenses                    | (5,118)   | (4,995)   | (4,678)   |
| Net investment income                       | \$ 55,608 | \$ 52,763 | \$ 58,831 |



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Pretax net realized investment gains (losses) and net changes in unrealized gains (losses) on investments for the years ended December 31 are summarized as follows:

| REALIZED/UNREALIZED GAINS<br>(in thousands)  | 2014      | 2013        | 2012      |
|--|-----------|-------------|-----------|
| Net realized investment gains (losses):  |           |             |           |
| Fixed income:  |           |             |           |
| Available-for-sale   | \$ 3,955  | \$ 1,338    | \$ 12,965 |
| Available-for-sale OTTI  | —         | —           | —         |
| Held-to-maturity   | 4         | 9           | 247       |
| Trading  | —         | —           | —         |
| Equity securities  | 29,468    | 21,533      | 16,245    |
| Equity securities OTTI   | —         | —           | (1,156)   |
| Other  | (1,245)   | (844)       | (2,929)   |
| Total  | \$ 32,182 | \$ 22,036   | \$ 25,372 |
| Net changes in unrealized gains(losses) on investments:  |           |             |           |
| Fixed income:  |           |             |           |
| Available-for-sale   | \$ 37,880 | \$ (75,228) | \$ 23,643 |
| Equity securities  | 17,300    | 64,305      | 16,212    |
| Total  | \$ 55,180 | \$ (10,923) | \$ 39,855 |
| Net realized investment gains (losses) and changes in unrealized gains (losses) on investments | \$ 87,362 | \$ 11,113   | \$ 65,227 |

During 2014, we recorded \$32.2 million in net realized gains along with a change in unrealized gains of \$55.2 million. The majority of our net realized gains were due to sales of equity securities while the change in unrealized gains was due to increases in the fixed income and equity portfolios. For 2014, the net realized investment gains and changes in unrealized gains (losses) on investments totaled \$87.4 million.

The following is a summary of the disposition of fixed income securities and equities for the years ended December 31, with separate presentations for sales and calls/maturities.

| SALES<br>(in thousands) | Proceeds<br>From Sales | Gross Realized<br>Gains | Losses     | Net<br>Realized<br>Gain (Loss) |
|-------------------------|------------------------|-------------------------|------------|--------------------------------|
| 2014                    |                        |                         |            |                                |
| Available-for-sale      | \$ 342,308             | \$ 7,208                | \$ (3,664) | \$ 3,544                       |
| Held-to-maturity        | 654                    | 4                       | —          | 4                              |
| Trading                 | —                      | —                       | —          | —                              |
| Equities                | 72,869                 | 29,794                  | (326)      | 29,468                         |

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|                    |            |           |            |           |
|--------------------|------------|-----------|------------|-----------|
| 2013               |            |           |            |           |
| Available-for-sale | \$ 173,694 | \$ 3,561  | \$ (2,597) | \$ 964    |
| Held-to-maturity   | —          | —         | —          | —         |
| Trading            | —          | —         | —          | —         |
| Equities           | 73,982     | 21,542    | (9)        | 21,533    |
| 2012               |            |           |            |           |
| Available-for-sale | \$ 181,338 | \$ 11,208 | \$ (43)    | \$ 11,165 |
| Held-to-maturity   | —          | —         | —          | —         |
| Trading            | —          | —         | —          | —         |
| Equities           | 78,315     | 19,755    | (3,510)    | 16,245    |

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| CALLS/MATURITIES<br>(in thousands) | Proceeds   | Gross Realized |        | Net<br>Realized |
|------------------------------------|------------|----------------|--------|-----------------|
|                                    |            | Gains          | Losses | Gain (Loss)     |
| 2014                               |            |                |        |                 |
| Available-for-sale                 | \$ 101,517 | \$ 414         | \$ (3) | \$ 411          |
| Held-to-maturity                   | —          | —              | —      | —               |
| Trading                            | —          | —              | —      | —               |
| 2013                               |            |                |        |                 |
| Available-for-sale                 | \$ 224,620 | \$ 379         | \$ (5) | \$ 374          |
| Held-to-maturity                   | 11,090     | 9              | —      | 9               |
| Trading                            | 1          | —              | —      | —               |
| 2012                               |            |                |        |                 |
| Available-for-sale                 | \$ 248,134 | \$ 1,806       | \$ (6) | \$ 1,800        |
| Held-to-maturity                   | 273,816    | 247            | —      | 247             |
| Trading                            | —          | —              | —      | —               |

## FAIR VALUE MEASUREMENTS

Assets measured at fair value on a recurring basis as of December 31, 2014, are summarized below:

| (in thousands)                      | Quoted in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total        |
|-------------------------------------|--|---|--|--------------|
| Available-for-sale securities:      |  |   |  |              |
| U.S. agency                         | \$ —   | \$ 6,747  | \$ —   | \$ 6,747     |
| Corporate                           | —  | 562,690   | —  | 562,690      |
| Agency MBS                          | —  | 264,468   | —  | 264,468      |
| ABS/CMBS*                           | —  | 135,304   | —  | 135,304      |
| Non-U.S. govt. & agency             | —  | 10,665  | —  | 10,665       |
| U.S. government                     | —  | 33,788  | —  | 33,788       |
| 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 & commercial mortgage-backed

Assets measured at fair value on a recurring basis as of December 31, 2013, are summarized below:

| (in thousands)                      | Quoted in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total        |
|-------------------------------------|--|---|--|--------------|
| Available-for-sale securities:      |  |   |  |              |
| U.S. agency                         | \$ —   | \$ 10,298   | \$ —   | \$ 10,298    |
| Corporate                           | —  | 526,038   | —  | 526,038      |
| Agency MBS                          | —  | 244,416   | —  | 244,416      |
| ABS/CMBS*                           | —  | 106,309   | —  | 106,309      |
| Non-U.S. govt. & agency             | —  | 13,678  | —  | 13,678       |
| U.S. government                     | —  | 17,303  | —  | 17,303       |
| Municipal                           | —  | 522,010   | —  | 522,010      |
| Equity                              | 418,654  | —   | —  | 418,654      |
| Total available-for-sale securities | \$ 418,654   | \$ 1,440,052  | \$ —   | \$ 1,858,706 |

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

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As noted in the previous tables, we did not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2014 and 2013. Additionally, there were no securities transferred in or out of levels 1 or 2 during 2014 or 2013.

The amortized cost and estimated fair value of fixed income securities at December 31, 2014, by contractual maturity, are shown as follows:

| (in thousands)                        | Amortized Cost | Fair Value   |
|---------------------------------------|----------------|--------------|
| Available-for-sale                    |                |              |
| Due in one year or less               | \$ 19,147      | \$ 19,368    |
| Due after one year through five years | 219,567        | 229,146      |
| Due after five years through 10 years | 570,196        | 587,807      |
| Due after 10 years                    | 248,956        | 258,994      |
| Mtge/ABS/CMBS*                        | 390,338        | 399,772      |
| Total available-for-sale              | \$ 1,448,204   | \$ 1,495,087 |

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

Expected maturities may differ from contractual maturities due to call provisions on some existing securities. At December 31, 2014, the net unrealized appreciation of available-for-sale fixed income and equity securities totaled \$264.0 million pretax. At December 31, 2013, the net unrealized appreciation of available-for-sale fixed maturities and equity securities totaled \$208.8 million pretax.

In addition, the following table is a schedule of amortized costs and estimated fair values of investments in fixed income and equity securities as of December 31, 2014 and 2013:

| 2014<br>(in thousands)  | Amortized<br>Cost | Fair Value | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses |
|-------------------------|-------------------|------------|---------------------------|----------------------------|
| Available-for-sale:     |                   |            |                           |                            |
| U.S. government         | \$ 33,668         | \$ 33,788  | \$ 131                    | \$ (11)                    |
| U.S. agency             | 6,385             | 6,747      | 362                       | —                          |
| Non-U.S. govt. & agency | 9,862             | 10,665     | 803                       | —                          |
| Mtge/ABS/CMBS*          | 390,337           | 399,772    | 11,222                    | (1,787)                    |
| Corporate               | 543,183           | 562,690    | 23,697                    | (4,190)                    |
| Municipal               | 464,769           | 481,425    | 16,789                    | (133)                      |

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|                          |              |              |            |            |
|--------------------------|--------------|--------------|------------|------------|
| Total fixed income       | \$ 1,448,204 | \$ 1,495,087 | \$ 53,004  | \$ (6,121) |
| Equity securities        | 193,535      | 410,642      | 218,105    | (998)      |
| Total available-for-sale | \$ 1,641,739 | \$ 1,905,729 | \$ 271,109 | \$ (7,119) |
| Held-to-maturity:        |              |              |            |            |
| Municipal                | \$ —         | \$ —         | \$ —       | \$ —       |
| Total held-to-maturity   | \$ —         | \$ —         | \$ —       | \$ —       |
| Trading**                |              |              |            |            |
| Total                    | \$ 1,641,739 | \$ 1,905,729 | \$ 271,109 | \$ (7,119) |

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

\*\*Trading securities are carried at fair value with unrealized gains (losses) included in earnings

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| 2013<br>(in thousands)   | Amortized<br>Cost | Fair Value   | Gross Unrealized |             |
|--------------------------|-------------------|--------------|------------------|-------------|
|                          |                   |              | Gains            | Losses      |
| Available-for-sale:      |                   |              |                  |             |
| U.S. government          | \$ 17,086         | \$ 17,303    | \$ 217           | \$ —        |
| U.S. agency              | 10,513            | 10,298       | 22               | (237)       |
| Non-U.S. govt. & agency  | 13,306            | 13,678       | 437              | (65)        |
| Mtge/ABS/CMBS*           | 350,187           | 350,725      | 8,188            | (7,650)     |
| Corporate                | 511,748           | 526,038      | 22,302           | (8,012)     |
| Municipal                | 528,209           | 522,010      | 6,495            | (12,694)    |
| Total fixed income       | \$ 1,431,049      | \$ 1,440,052 | \$ 37,661        | \$ (28,658) |
| Equity securities        | 218,848           | 418,654      | 200,081          | (275)       |
| Total available-for-sale | \$ 1,649,897      | \$ 1,858,706 | \$ 237,742       | \$ (28,933) |
| Held-to-maturity:        |                   |              |                  |             |
| Municipal                | \$ 651            | \$ 687       | \$ 36            | \$ —        |
| Total held-to-maturity   | \$ 651            | \$ 687       | \$ 36            | \$ —        |
| Trading**                |                   |              |                  |             |
| Total                    | \$ —              | \$ —         | \$ —             | \$ —        |
| Total                    | \$ 1,650,548      | \$ 1,859,393 | \$ 237,778       | \$ (28,933) |

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

\*\*Trading securities are carried at fair value with unrealized gains (losses) included in earnings

#### Mortgage-Backed, Commercial Mortgage-Backed and Asset-Backed Securities

Unrealized losses in the collateralized securities bond portfolio decreased to \$1.8 million in 2014 due to the decrease in interest rates during the year. All of our collateralized securities carry the highest credit rating by one or more major rating agency and continue to pay according to contractual terms.

For all fixed income securities at a loss at December 31, 2014, we believe it is probable that we will receive all contractual payments in the form of principal and interest. In addition, we are not required to, nor do we intend to sell these investments prior to recovering the entire amortized cost basis of each security, which may be maturity. We do not consider these investments to be other-than-temporarily impaired at December 31, 2014.

#### Corporate Bonds

Unrealized losses in the corporate bond portfolio decreased to \$4.2 million in 2014 from \$8.0 million at the end of 2013 as interest rates decreased during the year. While these unrealized losses are not due to credit-specific issues, the energy sector experienced a shift in risk premiums higher near year-end; wider credit spreads in energy were largely due to a rapid decline in oil and a repricing of risk for related companies. The corporate bond portfolio has an overall rating of BBB.

#### Municipal Bonds

As of December 31, 2014, municipal bonds totaled \$481.4 million with gross unrealized losses of \$0.1 million, down from \$12.7 of unrealized losses at the end of 2013. The decline was due to lower interest rates in conjunction with narrower risk premiums or tighter spreads when compared to last year. As of December 31, 2014, approximately 49 percent of the municipal fixed income securities in the investment portfolio were general obligations of state and local governments and the remaining 51 percent were revenue based. Ninety percent of our municipal fixed income securities were rated AA or better while 99 percent were rated A or better.

#### Equity Securities

Our equity portfolio consists of common stocks and exchange traded funds (ETF). Unrealized losses in the equity portfolio increased \$0.7 million to \$1.0 million in 2014. Given our intent to hold and expectation of recovery to cost within a reasonable period of time, we do not consider any of our equities to be other-than-temporarily impaired.

Under current accounting standards, an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered by circumstances where (1) an entity has the intent to sell a security, (2) it is more likely than not that the entity will



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

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

The following table is also used as part of our impairment analysis and displays the total value of securities that were in an unrealized loss position as of December 31, 2014, and December 31, 2013. The table segregates 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 table further classifies the securities based on the length of time they have been in an unrealized loss position.

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| (in thousands)                | December 31, 2014 |                      |            | December 31, 2013 |                      |             |
|-------------------------------|-------------------|----------------------|------------|-------------------|----------------------|-------------|
|                               | < 12 Mos.         | 12 Mos.<br>& Greater | Total      | < 12 Mos.         | 12 Mos. &<br>Greater | Total       |
| <b>U.S. Government</b>        |                   |                      |            |                   |                      |             |
| Fair value                    | \$ 4,416          | \$ —                 | \$ 4,416   | \$ —              | \$ —                 | \$ —        |
| Cost or amortized cost        | 4,427             | —                    | 4,427      | —                 | —                    | —           |
| Unrealized Loss               | \$ (11)           | \$ —                 | \$ (11)    | \$ —              | \$ —                 | \$ —        |
| <b>U.S. Agency</b>            |                   |                      |            |                   |                      |             |
| Fair value                    | \$ —              | \$ —                 | \$ —       | \$ 5,760          | \$ —                 | \$ 5,760    |
| Cost or amortized cost        | —                 | —                    | —          | 5,997             | —                    | 5,997       |
| Unrealized Loss               | \$ —              | \$ —                 | \$ —       | \$ (237)          | \$ —                 | \$ (237)    |
| <b>Non-U.S. Government</b>    |                   |                      |            |                   |                      |             |
| Fair value                    | \$ —              | \$ —                 | \$ —       | \$ 1,825          | \$ —                 | \$ 1,825    |
| Cost or amortized cost        | —                 | —                    | —          | 1,890             | —                    | 1,890       |
| Unrealized Loss               | \$ —              | \$ —                 | \$ —       | \$ (65)           | \$ —                 | \$ (65)     |
| <b>Agency MBS</b>             |                   |                      |            |                   |                      |             |
| Fair value                    | \$ 12,840         | \$ 61,534            | \$ 74,374  | \$ 118,283        | \$ —                 | \$ 118,283  |
| Cost or amortized cost        | 12,947            | 62,803               | 75,750     | 124,034           | —                    | 124,034     |
| Unrealized Loss               | \$ (107)          | \$ (1,269)           | \$ (1,376) | \$ (5,751)        | \$ —                 | \$ (5,751)  |
| <b>ABS/CMBS*</b>              |                   |                      |            |                   |                      |             |
| Fair value                    | \$ 63,782         | \$ 11,616            | \$ 75,398  | \$ 54,115         | \$ —                 | \$ 54,115   |
| Cost or amortized cost        | 64,084            | 11,725               | 75,809     | 56,014            | —                    | 56,014      |
| Unrealized Loss               | \$ (302)          | \$ (109)             | \$ (411)   | \$ (1,899)        | \$ —                 | \$ (1,899)  |
| <b>Corporate</b>              |                   |                      |            |                   |                      |             |
| Fair value                    | \$ 123,617        | \$ 14,488            | \$ 138,105 | \$ 190,470        | \$ 2,245             | \$ 192,715  |
| Cost or amortized cost        | 127,634           | 14,661               | 142,295    | 198,250           | 2,477                | 200,727     |
| Unrealized Loss               | \$ (4,017)        | \$ (173)             | \$ (4,190) | \$ (7,780)        | \$ (232)             | \$ (8,012)  |
| <b>Municipal</b>              |                   |                      |            |                   |                      |             |
| Fair value                    | \$ 12,382         | \$ 19,019            | \$ 31,401  | \$ 309,407        | \$ 943               | \$ 310,350  |
| Cost or amortized cost        | 12,411            | 19,123               | 31,534     | 322,095           | 949                  | 323,044     |
| Unrealized Loss               | \$ (29)           | \$ (104)             | \$ (133)   | \$ (12,688)       | \$ (6)               | \$ (12,694) |
| <b>Subtotal, fixed income</b> |                   |                      |            |                   |                      |             |
| Fair value                    | \$ 217,037        | \$ 106,657           | \$ 323,694 | \$ 679,860        | \$ 3,188             | \$ 683,048  |
| Cost or amortized cost        | 221,503           | 108,312              | 329,815    | 708,280           | 3,426                | 711,706     |
| Unrealized Loss               | \$ (4,466)        | \$ (1,655)           | \$ (6,121) | \$ (28,420)       | \$ (238)             | \$ (28,658) |
| <b>Equity securities</b>      |                   |                      |            |                   |                      |             |

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|                        |            |            |            |             |          |             |
|------------------------|------------|------------|------------|-------------|----------|-------------|
| Fair value             | \$ 10,837  | \$ —       | \$ 10,837  | \$ 2,394    | \$ —     | \$ 2,394    |
| Cost or amortized cost | 11,835     | —          | 11,835     | 2,669       | —        | 2,669       |
| Unrealized Loss        | \$ (998)   | \$ —       | \$ (998)   | \$ (275)    | \$ —     | \$ (275)    |
| <b>Total</b>           |            |            |            |             |          |             |
| Fair value             | \$ 227,874 | \$ 106,657 | \$ 334,531 | \$ 682,254  | \$ 3,188 | \$ 685,442  |
| Cost or amortized cost | 233,338    | 108,312    | 341,650    | 710,949     | 3,426    | 714,375     |
| Unrealized Loss        | \$ (5,464) | \$ (1,655) | \$ (7,119) | \$ (28,695) | \$ (238) | \$ (28,933) |

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

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As of December 31, 2014, we held four equity securities that were in unrealized loss positions. The total unrealized loss on these securities was \$1.0 million. In considering both the significance and duration of the unrealized loss position, we have no equity securities in an unrealized loss position of greater than 20 percent for more than six consecutive months.

The fixed income portfolio contained 258 securities in an unrealized loss position as of December 31, 2014. Of these 258 securities, 49 have been in an unrealized loss position for 12 consecutive months or longer and represent \$1.7 million in unrealized losses. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. Credit-related impairments on fixed income securities that we do not plan to sell, and for which we are not more likely than not to be required to sell, are recognized in net earnings. Any non-credit related impairment is recognized in comprehensive earnings. Based on our analysis, our fixed income portfolio is of a high credit quality and we believe we will recover the amortized cost basis of our fixed income securities. We continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. There were no OTTI losses recognized in other comprehensive earnings in the periods presented. Key factors that we consider in the evaluation of credit quality include:

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

Based on our analysis, we concluded that the securities in an unrealized loss position were not other-than-temporarily impaired at December 31, 2014, and 2013.

During 2014 and 2013, we did not recognize any impairment losses. There were \$1.2 million in losses associated with OTTI of securities in 2012.

As required by law, certain fixed maturity investments amounting to \$28.1 million at December 31, 2014, were on deposit with either regulatory authorities or banks.

Other Invested Assets

Other invested assets shown on the balance sheet as of December 31, 2014 include an investment in a low income housing tax credit partnership as well as membership stock in the Federal Home Loan Bank of Chicago (FHLBC). During 2014, we recorded an interest in a low income housing tax credit partnership totaling \$10.0 million. The interest had a balance of \$9.8 million at December 31, 2014 and recognized a total tax benefit of \$0.2 million during the year. Our investment in FHLBC stock totaled \$1.8 million at the end of the year.

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## 3. POLICY ACQUISITION COSTS

Policy acquisition costs deferred and amortized to income for the years ended December 31 are summarized as follows:

| (in thousands)   | 2014       | 2013       | 2012       |
|--|------------|------------|------------|
| Deferred policy acquisition costs (DAC), beginning of year | \$ 61,508  | \$ 52,344  | \$ 52,105  |
| Deferred:  |            |            |            |
| Direct commissions   | \$ 142,887 | \$ 134,770 | \$ 129,765 |
| Premium taxes  | 10,727     | 10,442     | 9,528      |
| Ceding commissions   | (20,483)   | (20,186)   | (29,010)   |
| Net deferred   | \$ 133,131 | \$ 125,026 | \$ 110,283 |
| Amortized  | 129,516    | 115,862    | 110,044    |
| DAC/VOBA*, end of year                                     | \$ 65,123  | \$ 61,508  | \$ 52,344  |
| Policy acquisition costs:                                  |            |            |            |
| Amortized to expense - DAC                                 | \$ 129,346 | \$ 115,442 | \$ 107,482 |
| Amortized to expense - VOBA                                | 170        | 420        | 2,562      |
| Period costs:  |            |            |            |
| Ceding commission - contingent                             | (1,956)    | (2,126)    | (1,940)    |
| Other underwriting expenses                                | 101,723    | 96,915     | 88,258     |
| Total policy acquisition costs                             | \$ 229,283 | \$ 210,651 | \$ 196,362 |

\*Includes asset for value of business acquired (VOBA) in CBIC acquisition.

## 4. DEBT

As of December 31, 2014, outstanding debt balances totaled \$149.6 million, net of unamortized discount, all of which were our long-term senior notes.

On October 2, 2013, we completed a public debt offering, issuing \$150.0 million in senior notes maturing September 15, 2023, and paying interest semi-annually at the rate of 4.875 percent. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$148.6 million. The amount of the discount is being charged to income over the life of the debt on an effective-yield basis. On December 12, 2013, a portion of the proceeds were used to redeem the \$100.0 million in senior notes that were to mature on January 15, 2014, and the remaining proceeds were made available for general corporate purposes. The estimated fair value for the senior note is \$159.0 million. The fair value of our long-term debt is estimated based on the limited observable prices that reflect thinly traded securities.

In 2014, 2013 and 2012, we incurred interest expense on our senior notes in the amounts of \$7.4 million, \$8.1 million and \$6.0 million, respectively. The average rate on debt in 2014, 2013 and 2012 was 4.91 percent, 5.71 percent and 6.02 percent, respectively.

We 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. This facility has a four-year term that expires on May 28, 2018. As of and during the years ended December 31, 2014, 2013 and 2012, no amounts were outstanding on these facilities.

## 5. REINSURANCE

In the ordinary course of business, the insurance subsidiaries assume and cede premiums and selected insured risks with other insurance companies, known as reinsurance. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk (known as facultative reinsurance). In addition, there are several types of treaties including quota share, excess of loss and catastrophe reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. The arrangements allow us to pursue greater diversification of business and serve to limit the maximum net loss to a single event, such as a catastrophe. Through the quantification of exposed policy limits in each region and the extensive use of computer-assisted modeling techniques, we monitor the concentration of risks exposed to catastrophic events.

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Through the purchase of reinsurance, we also generally limit our net loss on any individual risk to a maximum of \$3.0 million, although retentions can range from \$1.0 million to \$8.8 million.

Premiums written and earned along with losses and settlement expenses incurred for the years ended December 31 are summarized as follows:

| (in thousands)                                 | 2014       | 2013       | 2012       |
|--|------------|------------|------------|
| <b>WRITTEN</b>                                 |            |            |            |
| Direct   | \$ 787,267 | \$ 770,142 | \$ 709,107 |
| Reinsurance assumed                            | 76,581     | 73,053     | 75,692     |
| Reinsurance ceded                              | (160,696)  | (176,873)  | (191,713)  |
| Net  | \$ 703,152 | \$ 666,322 | \$ 593,086 |
| <b>EARNED</b>                                  |            |            |            |
| Direct   | \$ 781,640 | \$ 741,569 | \$ 679,124 |
| Reinsurance assumed                            | 72,878     | 78,891     | 77,597     |
| Reinsurance ceded                              | (167,143)  | (189,658)  | (180,150)  |
| Net  | \$ 687,375 | \$ 630,802 | \$ 576,571 |
| <b>LOSSES AND SETTLEMENT EXPENSES INCURRED</b> |            |            |            |
| Direct   | \$ 315,226 | \$ 279,358 | \$ 282,859 |
| Reinsurance assumed                            | 61,923     | 72,508     | 69,830     |
| Reinsurance ceded                              | (80,540)   | (92,065)   | (81,044)   |
| Net  | \$ 296,609 | \$ 259,801 | \$ 271,645 |

The assumed business is made up of short-tail property, casualty, catastrophe and multi-peril crop and hail reinsurance. The majority of this assumed reinsurance is proportional and a large portion of the assumed incurred losses can be attributed to crop-related reinsurance, which we began offering in 2010 and will expire over the next year, and a specialty property treaty. Losses for each crop season are ultimately determined and paid subsequent to December 31 of the crop year reinsured.

At December 31, 2014, we had prepaid reinsurance premiums and recoverables on paid and unpaid losses and settlement expenses totaling \$355.5 million. More than 96 percent of our reinsurance recoverables are due from companies with financial strength ratings of "A" or better by A.M. Best and S&P rating services.

The following table displays net reinsurance balances recoverable, after consideration of collateral, from our top 10 reinsurers as of December 31, 2014. These reinsurers all have financial strength ratings of "A" or better by A.M. Best



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and Standard and Poor's ratings services. Also shown are the amounts of written premium ceded to these reinsurers during the calendar year 2014.

| (dollars in thousands)            | A.M. Best<br>Rating | S & P<br>Rating  | Net Reinsurer<br>Exposure as of<br>12/31/2014 | Percent of<br>Total |   | Ceded<br>Premiums<br>Written | Percent of<br>Total |   |
|-----------------------------------|---------------------|------------------|---|---------------------|---|------------------------------|---------------------|---|
| Munich Re America /<br>HSB        | A+, Superior        | AA-, Very Strong | \$ 64,374                                     | 18.1                | % | \$ 21,080                    | 13.1                | % |
| Endurance Re                      | A, Excellent        | A, Strong        | 57,860  | 16.3                | % | 13,761                       | 8.6                 | % |
| Aspen UK Ltd.                     | A, Excellent        | A, Strong        | 35,095  | 9.9                 | % | 8,073                        | 5.0                 | % |
| Swiss Re / Westport<br>Ins. Corp. | A+, Superior        | AA-, Very Strong | 25,736  | 7.2                 | % | 8,162                        | 5.1                 | % |
| Transatlantic Re                  | A, Excellent        | A+, Strong       | 25,599  | 7.2                 | % | 9,605                        | 6.0                 | % |
| Berkley Insurance Co.             | A+, Superior        | A+, Strong       | 22,611  | 6.4                 | % | 6,255                        | 3.9                 | % |
| Allied World Re - US              | A, Excellent        | A, Strong        | 15,788  | 4.4                 | % | 4,061                        | 2.5                 | % |
| Axis Re                           | A+, Superior        | A+, Strong       | 15,557  | 4.4                 | % | 5,059                        | 3.1                 | % |
| General Re                        | A++,<br>Superior    | AA+, Very Strong | 11,474  | 3.2                 | % | 2,630                        | 1.6                 | % |
| Toa-Re                            | A+, Superior        | A+, Strong       | 11,070  | 3.1                 | % | 3,074                        | 1.9                 | % |
| All other reinsurers*             |                     |                  | 70,331  | 19.8                | % | 78,936                       | 49.2                | % |
| Total ceded exposure              |                     |                  | \$ 355,495                                    | 100.0               | % | \$ 160,696                   | 100.0               | % |

\*All other reinsurance balances recoverable, when considered by individual reinsurer, are less than 2 percent of shareholders' equity.

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Ceded unearned premiums and reinsurance balances recoverable on paid losses and settlement expenses are reported separately as an asset, rather than being netted with the related liability, since reinsurance does not relieve us of our liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. We continually monitor the financial condition of our reinsurers and actively follow up on any past due or disputed amounts. As part of our monitoring efforts, we review their annual financial statements and SEC filings for those reinsurers that are publicly traded. We also review insurance industry developments that may impact the financial condition of our reinsurers. We analyze the credit risk associated with our reinsurance balances recoverable by monitoring the A.M. Best and S&P ratings of our reinsurers. In addition, we subject our reinsurance recoverables to detailed recoverability tests, including a segment based analysis using the average default rating percentage by S&P rating, which assists us in assessing the sufficiency of the existing allowance. Additionally, we perform an in-depth reinsurer financial condition analysis prior to the renewal of our reinsurance placements.

Our policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that we may be unable to recover. Once regulatory action (such as receivership, finding of insolvency, order of conservation or order of liquidation) is taken against a reinsurer, the paid and unpaid recoverable for the reinsurer are specifically identified and written off through the use of our allowance for estimated unrecoverable amounts from reinsurers. When we write-off such a balance, it is done in full. We then re-evaluate the remaining allowance and determine whether the balance is sufficient as detailed above and if needed, an additional allowance is recognized and income charged. The amounts of allowances for uncollectible amounts on paid and unpaid recoverables were \$13.3 million and \$13.1 million, respectively, at December 31, 2014. At December 31, 2013, the amounts were \$12.2 million and \$14.2 million, respectively. We have no receivables with a due date that extends beyond one year that are not included in our allowance for uncollectible amounts, other than the receivable related to our crop reinsurance program. The amount receivable under our crop reinsurance business, which represents \$23.7 million of our total premiums and reinsurance balances receivable at December 31, 2014, is not contractually due until the final settlement of the 2014 crop year, which is scheduled to occur during the fourth quarter of 2015.

## 6. HISTORICAL LOSS AND LAE DEVELOPMENT

The following table is a reconciliation of our unpaid losses and settlement expenses (LAE) for the years 2014, 2013 and 2012.

| (in thousands)                              | 2014         | 2013         | 2012         |
|---|--------------|--------------|--------------|
| Unpaid losses and LAE at beginning of year: |              |              |              |
| Gross                                       | \$ 1,129,433 | \$ 1,158,483 | \$ 1,150,714 |
| Ceded                                       | (354,924)    | (359,884)    | (353,805)    |
| Net   | \$ 774,509   | \$ 798,599   | \$ 796,909   |

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|   |              |              |              |
|---|--------------|--------------|--------------|
| Increase (decrease) in incurred losses and LAE: |              |              |              |
| Current accident year                           | \$ 361,451   | \$ 332,282   | \$ 336,228   |
| Prior accident years                            | (64,842)     | (72,481)     | (64,583)     |
| Total incurred                                  | \$ 296,609   | \$ 259,801   | \$ 271,645   |
| Loss and LAE payments for claims incurred:      |              |              |              |
| Current accident year                           | \$ (65,308)  | \$ (57,537)  | \$ (69,785)  |
| Prior accident year                             | (219,876)    | (226,354)    | (200,170)    |
| Total paid                                      | \$ (285,184) | \$ (283,891) | \$ (269,955) |
| Net unpaid losses and LAE at end of year        | \$ 785,934   | \$ 774,509   | \$ 798,599   |
| Unpaid losses and LAE at end of year:           |              |              |              |
| Gross   | \$ 1,121,040 | \$ 1,129,433 | \$ 1,158,483 |
| Ceded   | (335,106)    | (354,924)    | (359,884)    |
| Net   | \$ 785,934   | \$ 774,509   | \$ 798,599   |

The differences from our initial reserve estimates emerged as changes in our ultimate loss estimates as we updated those estimates through our reserve analysis process. The recognition of the changes in initial reserve estimates occurred over time as claims were reported, initial case reserves were established, initial reserves were reviewed in light of additional information and ultimate payments were made on the collective set of claims incurred as of that evaluation date. The new information on the

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ultimate settlement value of claims is continually updated until all claims in a defined set are settled. As a small specialty insurer with a diversified product portfolio, our experience will ordinarily exhibit fluctuations from period to period. While we attempt to identify and react to systematic changes in the loss environment, we also must consider the volume of experience directly available to us and interpret any particular period's indications with a realistic technical understanding of the reliability of those observations.

The following table summarizes our prior accident years' loss reserve development by segment for 2014, 2013 and 2012:

(FAVORABLE)/UNFAVORABLE RESERVE  
DEVELOPMENT BY SEGMENT

| (in thousands) | 2014        | 2013        | 2012        |
|----------------|-------------|-------------|-------------|
| Casualty       | \$ (52,825) | \$ (61,805) | \$ (40,449) |
| Property       | (1,123)     | (7,273)     | (16,800)    |
| Surety         | (10,894)    | (3,403)     | (7,334)     |
| Total          | \$ (64,842) | \$ (72,481) | \$ (64,583) |

A discussion of significant components of reserve development for the three most recent calendar years follows:

2014. We experienced favorable emergence relative to prior years' reserve estimates in all our segments during 2014. The casualty segment contributed \$52.8 million in favorable development. Accident years 2012 and 2013 contributed significantly to the favorable development, with accident years 2007 to 2011 also continuing to develop favorably. The favorable development in 2014 was smaller than 2013. This was predominantly caused by favorable frequency and severity trends that continued to be better than our long-term expectations. In addition, we believe this to be the result of our underwriters' risk selection, which has mostly offset price declines and loss cost inflation. Nearly all of our casualty products contributed to the favorable development, but this was particularly true for our general liability product. The general liability product contributed \$28.1 million to our favorable development with all coverages contributing to the favorable development in 2014. P&C package products were the second largest contributor with \$9.4 million in favorable development mostly from accident years 2011, 2012 and 2013. Personal and commercial umbrella were favorable by \$0.8 million and \$4.4 million, respectively. Run-off business had favorable development of \$0.9 million due mostly to favorable development in the discontinued restaurant-bar-tavern business.

The marine product was the primary driver of the favorable development in the property segment. Marine contributed \$5.8 million of the \$1.1 million total favorable property development. Accident years 2012 and 2013 contributed to the marine products' favorable development. Assumed property and crop were unfavorable by \$4.0 million and \$1.2 million, respectively. The unfavorable assumed property development was primarily attributable to 2012 spring storms on a treaty, covering mostly Texas homeowners, which was cancelled in early 2013.

The surety segment experienced favorable development of \$10.9 million. The majority of the favorable development was from accident year 2013. Contract and commercial surety products were the main contributors with favorable development of \$4.6 million and \$4.3 million, respectively. Oil and gas surety had favorable development of \$1.2 million and miscellaneous surety had favorable development of \$0.9 million.

2013. We experienced favorable emergence relative to prior years' reserve estimate in all our segments during 2013. The casualty segment contributed \$61.8 million in favorable development. Accident year 2012 contributed significantly to the favorable development, with accident years 2008 to 2011 also continuing to develop favorably. The favorable development in 2013 was larger than 2012 and reflects the continuing favorable frequency and severity trends. In addition, the risk selection by our underwriters continued to provide results better than estimated in our reserving process. The general liability product contributed \$28.5 million to our favorable development with all coverages, including habitational contributing to the favorable development in 2013. Executive products were the second largest contributor with \$8.9 million in favorable development mostly from accident year 2011. Personal and commercial umbrella were favorable by \$7.5 million and \$6.5 million respectively. P&C package products were favorable by \$8.1 million. Our run-off program business was favorable by \$2.0 million mostly from the discontinued restaurant-bar-tavern business. Transportation and miscellaneous professional liability were the only products unfavorable at \$3.5 million and \$0.5 million, respectively.

The marine product was the primary driver of the favorable development in the property segment. Marine contributed \$5.9 million of the \$7.3 million total favorable property development. Accident year 2009 to 2012 contributed to the marine products' favorable development. The marine protection & indemnity and liability coverages accounted for the majority of the favorable

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development. Other direct property products contributed \$3.5 million favorable development offsetting the unfavorable development of \$1.4 million in the assumed property.

The surety segment experienced favorable development of \$3.4 million. The majority of the favorable development was from accident year 2012, which offset the unfavorable development from accident years 2009 to 2011. The adverse development coincided with the economic environment in those years. The majority of the adverse development was from the contract and miscellaneous surety products. Though accident year 2012 was favorable for all of surety combined, oil and gas surety was unfavorable in accident year 2012.

2012. We experienced favorable emergence relative to prior years' reserve estimates in all of our segments during 2012. Development from the casualty segment totaled \$40.4 million with the largest amounts coming from accident years 2007 through 2010. We continue to experience emergence that is generally better than previously estimated, but to a lesser degree in 2012 than in the previous two years. Frequency and severity trends have been favorable relative to initial estimates and we believe this is largely due to risk selection by our underwriters, which has been effective in offsetting loss cost trends and a competitive pricing environment. Our general liability product was the largest single contributor to this favorable development at \$14.2 million. Although the habitational classes within this product produced adverse development, it was more than offset by favorable development from the construction classes. The second largest contributor was our personal umbrella product at \$11.5 million and we also had a favorable contribution of \$4.9 million from our commercial umbrella products. In addition, our active program business combined for \$9.2 million of favorable development, coming mostly from the P&C package products that were added in 2011. Our run-off program business contributed \$4.6 million of favorable development coming mostly from the discontinued restaurant-bar-tavern class. Two business units experienced adverse development in 2012. Transportation and executive products were unfavorable by \$3.2 million and \$2.2 million, respectively.

For the second year in a row, our marine product was the predominant driver of the favorable development in the property segment, accounting for \$12.1 million of the \$16.8 million total favorable development for the segment. The accident years making the largest contributions were 2008 through 2010. The marine protection & indemnity and liability coverages were responsible for the majority of the favorable loss experience. Our other direct property products contributed \$3.5 million of favorable development with the majority of that coming from loss reductions on previous hurricanes and storms. Development on assumed reinsurance business was also favorable overall.

The surety segment experienced \$7.3 million of favorable development with nearly all of it coming from accident years 2010 and 2011. The development from the commercial, miscellaneous and energy products more than offset \$2.6 million of unfavorable development from the contract surety product. Last year we started seeing evidence that the cumulative effect of the economic environment was having an adverse impact on our customers and our experience, in particular for contract surety. This continued during 2012 causing us to increase our estimates for contract surety for prior accident years, in particular accident year 2011.

ENVIRONMENTAL, ASBESTOS AND MASS TORT EXPOSURES

We are subject to environmental site cleanup, asbestos removal and mass tort claims and exposures through our commercial umbrella, general liability and discontinued assumed casualty reinsurance lines of business. The majority of the exposure is in the excess layers of our commercial umbrella and assumed reinsurance books of business.

The following table represents paid and unpaid environmental, asbestos and mass tort claims data (including incurred but not reported losses) as of December 31, 2014, 2013 and 2012:

| (in thousands)                              | 2014       | 2013       | 2012       |
|---|------------|------------|------------|
| <b>LOSS AND LAE PAYMENTS (CUMULATIVE)</b>   |            |            |            |
| Gross                                       | \$ 112,819 | \$ 105,559 | \$ 102,222 |
| Ceded                                       | (59,376)   | (57,976)   | (57,345)   |
| Net   | \$ 53,443  | \$ 47,583  | \$ 44,877  |
| <b>UNPAID LOSSES AND LAE AT END OF YEAR</b> |            |            |            |
| Gross                                       | \$ 39,064  | \$ 48,507  | \$ 50,353  |
| Ceded                                       | (11,879)   | (15,043)   | (16,733)   |
| Net   | \$ 27,185  | \$ 33,464  | \$ 33,620  |

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Our environmental, asbestos and mass tort exposure is limited, relative to other insurers, as a result of entering the affected liability lines after the insurance industry had already recognized environmental and asbestos exposure as a problem and adopted appropriate coverage exclusions. The majority of our reserves are associated with products that went into runoff at least two decades ago. Some are for assumed reinsurance, some are for excess liability business and some followed from the acquisition of Underwriters Indemnity Company in 1999.

Calendar year 2014 included a higher than normal increase in inception-to-date paid losses on a net and gross basis. The increase was largely due to a commutation completed during the year on assumed business from the early 1980's. The payment of the commutation resulted in a corresponding reduction in case reserves.

While our environmental exposure is limited, the ultimate liability for this exposure is difficult to assess because of the extensive and complicated litigation involved in the settlement of claims and evolving legislation on issues such as joint and several liability, retroactive liability and standards of cleanup. Additionally, we participate primarily in the excess layers of coverage, where accurate estimates of ultimate loss are more difficult to derive than for primary coverage.

## 7. INCOME TAXES

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are summarized as follows:

| (in thousands)                            | 2014      | 2013      |
|---|-----------|-----------|
| Deferred tax assets:                      |           |           |
| Tax discounting of claim reserves         | \$ 19,609 | \$ 22,200 |
| Unearned premium offset                   | 24,322    | 23,163    |
| Deferred compensation                     | 6,143     | 6,193     |
| Stock option expense                      | 5,046     | 4,160     |
| NOL carryforward                          | —         | 1,059     |
| Other                                     | 453       | 604       |
| Deferred tax assets before allowance      | \$ 55,573 | \$ 57,379 |
| Less valuation allowance                  | —         | —         |
| Total deferred tax assets                 | \$ 55,573 | \$ 57,379 |
| Deferred tax liabilities:                 |           |           |
| Net unrealized appreciation of securities | \$ 92,562 | \$ 73,198 |
| Deferred policy acquisition costs         | 22,793    | 21,528    |



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|  |             |             |
|--|-------------|-------------|
| Book/tax depreciation                              | 3,610       | 2,632       |
| Intangible assets from CBIC acquisition            | 3,594       | 4,235       |
| Undistributed earnings of unconsolidated investees | 14,728      | 12,995      |
| Other  | 571         | 592         |
| Total deferred tax liabilities                     | \$ 137,858  | \$ 115,180  |
| Net deferred tax liability                         | \$ (82,285) | \$ (57,801) |

Income tax expense attributable to income from operations for the years ended December 31, 2014, 2013 and 2012, differed from the amounts computed by applying the U.S. federal tax rate of 35 percent to pretax income from continuing operations as demonstrated in the following table:

| (in thousands)  | 2014      | 2013      | 2012      |
|---|-----------|-----------|-----------|
| Provision for income taxes at the statutory federal tax rates | \$ 66,320 | \$ 61,483 | \$ 49,956 |
| Increase (reduction) in taxes resulting from:                 |           |           |           |
| Dividends received deduction                                  | (2,390)   | (2,490)   | (2,630)   |
| ESOP dividends paid deduction                                 | (4,473)   | (2,532)   | (3,596)   |
| Tax-exempt interest income                                    | (4,118)   | (3,758)   | (2,995)   |
| Unconsolidated investee dividends                             | (1,848)   | (3,696)   | (1,848)   |
| Other items, net  | 551       | 404       | 499       |
| Total   | \$ 54,042 | \$ 49,411 | \$ 39,386 |

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Our effective tax rates were 28.5 percent, 28.1 percent and 27.6 percent for 2014, 2013 and 2012, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2014 was higher than 2013 due to an increase in net realized gains on investments along with a slight increase in underwriting income.

Dividends paid to our Employee Stock Ownership Plan (ESOP) result in a tax deduction. Special dividends paid to the ESOP in 2014, 2013 and 2012 resulted in tax benefits of \$3.6 million, \$1.7 million and \$2.9 million, respectively. These tax benefits reduced the effective tax rate for 2014, 2013 and 2012 by 1.9 percent, 1.0 percent and 2.0 percent, respectively.

Our net earnings include equity in earnings of unconsolidated investees, Maui Jim and Prime. The investees do not have a policy or pattern of paying dividends. As a result, we record a deferred tax liability on the earnings at the corporate capital gains rate of 35 percent. In the fourth quarters of 2014, 2013 and 2012, we received a \$6.6 million, \$13.2 million and \$6.6 million dividend from Maui Jim, respectively. In accordance with GAAP guidelines on income taxes, we recognized a \$1.8 million, \$3.7 million and \$1.8 million tax benefit for 2014, 2013 and 2012, respectively. The tax benefit is generated from applying the lower tax rate applicable to affiliated dividends (7 percent), as compared to the corporate capital gains rate on which the deferred tax liabilities were based. Standing alone the dividend resulted in a 1.0 percent, 2.1 percent and 1.3 percent reduction to the 2014, 2013 and 2012 effective tax rates, respectively. In determining the appropriate tax rate to apply, we anticipate recovering our investments through means other than the receipt of dividends, such as a sale.

We have recorded our deferred tax assets and liabilities using the statutory federal tax rate of 35 percent. We believe it is more likely than not that all deferred tax assets will be recovered given the carry back availability as well as the results of future operations, which will generate sufficient taxable income to realize the deferred tax asset. In addition, we believe when these deferred items reverse in future years, our taxable income will be taxed at an effective rate of 35 percent.

Federal and state income taxes paid in 2014, 2013 and 2012, amounted to \$48.5 million, \$36.8 million and \$25.9 million, respectively.

8. EMPLOYEE BENEFITS

EMPLOYEE STOCK OWNERSHIP, 401(K) AND BONUS AND INCENTIVE PLANS

We maintain ESOP, 401(k) and bonus and incentive plans covering executives, managers and associates. At the board of directors' discretion, funding of these plans is primarily dependent upon reaching predetermined levels of operating return on equity, combined ratio and Market Value Potential (MVP). MVP is a compensation model that measures components of comprehensive earnings against a minimum required return on our capital. Bonuses are earned as we generate earnings in excess of this required return. While some management incentive plans may be affected somewhat by other performance factors, the larger influence of corporate performance ensures that the interests of our executives, managers and associates correspond with those of our shareholders.

Our 401(k) plan allows voluntary contributions by employees and permits ESOP diversification transfers for employees meeting certain age or service requirements. We provide a basic 401(k) contribution of 3 percent of eligible compensation. Participants are 100 percent vested in both voluntary and basic contributions. Additionally, an annual discretionary profit-sharing contribution may be made to the ESOP and 401(k), subject to the achievement of certain overall financial goals and board approval. Profit-sharing contributions vest after three years of plan service.

Our ESOP and 401(k) cover all employees meeting eligibility requirements. ESOP and 401(k) profit-sharing contributions are determined annually by our board of directors and are expensed in the year earned. ESOP and 401(k)-related expenses (basic and profit-sharing) were \$14.1 million, \$12.4 million and \$7.8 million, for 2014, 2013 and 2012, respectively.

During 2014, the ESOP purchased 178,987 shares of RLI stock on the open market at an average price of \$44.43 (\$7.9 million) relating to the contribution for plan year 2013. Shares held by the ESOP as of December 31, 2014, totaled 3,482,617 and are treated as outstanding in computing our earnings per share. During 2013, the ESOP purchased 140,484 shares of RLI stock on the open market at an average price of \$35.03 (\$4.9 million) relating to the contribution for plan year 2012. During 2012, the ESOP purchased 189,282 shares of RLI stock on the open market at an average price of \$35.01 (\$6.6 million) relating to the contribution for plan year 2011. The above mentioned ESOP purchases relate only to our annual contributions to the plan and do not include amounts or shares resulting from the reinvestment of dividends.

Annual bonuses are awarded to executives, managers and associates through our incentive plans, provided certain financial and operational goals are met. Annual expenses for these incentive plans totaled \$23.1 million, \$23.2 million and \$16.7 million for 2014, 2013 and 2012, respectively.

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DEFERRED COMPENSATION

We maintain “rabbi trusts” for deferred compensation plans for directors, key employees and executive officers through which our shares are purchased. GAAP guidelines prescribe an accounting treatment whereby the employer stock in the plan is classified and accounted for as equity, in a manner consistent with the accounting for treasury stock.

In 2014, the trusts purchased 9,920 shares of our common stock on the open market at an average price of \$44.40 (\$0.4 million). In 2013, the trusts purchased 13,922 shares of our common stock on the open market at an average price of \$38.33 (\$0.5 million). In 2012, the trusts purchased 14,968 shares of our common stock on the open market at an average price of \$34.24 (\$0.5 million). At December 31, 2014, the trusts’ assets were valued at \$35.3 million.

STOCK OPTIONS AND STOCK PLANS

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 (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.

During the second quarter of 2010, our shareholders approved the RLI Corp. Long-Term Incentive Plan (LTIP), which provides for equity-based compensation and replaced the omnibus plan. In conjunction with the adoption of the LTIP, effective May 6, 2010, options were no longer granted under the omnibus plan. Awards under the LTIP may be in the form of restricted stock, stock options (nonqualified only), stock appreciation rights, performance units, as well as other stock-based awards. Eligibility under the LTIP is limited to employees or directors of the company or any affiliate. The granting of awards under the LTIP is solely at the discretion of the executive resources committee of the board of directors. The maximum number of shares of common stock available for distribution under the LTIP is 4,000,000 shares (subject to adjustment for changes in our capitalization and other events). Since 2010, we have granted 2,824,500 stock options under the LTIP, including 512,000 in 2014.

Under the LTIP, as under the omnibus plan, we grant stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant. Options generally vest and become exercisable ratably over a five-year period.

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

Shares issued may be less than the number of shares actually exercised, as our plan allows net settlement to cover the option exercise price and taxes due upon option exercise. Shares netted are valued at the closing stock price at the time of option exercise. In these instances, the actual number of shares issued will be less than the options exercised and can result in a decrease to shareholders' equity. Specifically, when options are exercised with significant intrinsic value (i.e. market value in excess of exercise price) and the exercise is facilitated via net settlement, amounts withheld for taxes result in a decrease in shareholders' equity. During 2013, the aggregate intrinsic value of options exercised was \$22.4 million. A majority of these options were exercised via net settlement with taxes withheld at the statutory minimum rate. As shown in the consolidated statements of shareholders' equity, the exercise of options in 2013 resulted in a decrease to paid-in-capital, as the taxes withheld pursuant to net settlement exceeded amounts paid in for options that were exercised using cash. This was not the case in 2014 or 2012 as the intrinsic value of the options exercised was not as significant (\$6.2 million and \$4.7 million, respectively). Therefore, the exercise of options in 2014 and 2012 resulted in increases to paid-in-capital.

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On November 13, 2014, the board of directors declared a \$3.00 per share special cash dividend to be paid on December 22, 2014, to shareholders of record at the close of business on November 28, 2014. To preserve the intrinsic value for option holders, the board also approved, pursuant to the terms of our various stock option plans, a proportional adjustment to both the exercise price and the number of shares covered by each award for all outstanding ISOs and an adjustment to the exercise price (equivalent to the special dividend) for all outstanding non-qualified options. Most (99 percent) of the outstanding options at the time of the adjustment were non-qualified. These adjustments did not result in any incremental compensation expense as the aggregate fair value, aggregate intrinsic value and the ratio of the exercise price to the market price are approximately equal immediately before and after the adjustment. Similarly, on November 14, 2013, the board of directors declared a \$1.50 per share special cash dividend to be paid on December 20, 2013, to shareholders of record at the close of business on November 29, 2013. On November 14, 2012, the board of directors declared a \$2.50 per share special cash dividend to be paid on December 20, 2012, to shareholders of record at the close of business on November 30, 2012. The share and exercise price adjustments made for the 2014 special dividend were also made for the 2013 and 2012 special dividends and did not result in any incremental compensation expense.

The following tables summarize option activity in 2014, 2013 and 2012:

|  | 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                          | 512,000                             | \$ 40.46                                 |   |   |
| Special dividend*                        | 415                                 | \$ 16.72                                 |   |   |
| Options exercised                        | (214,042)                           | \$ 18.93                                 |   | \$ 6,164                                      |
| Options canceled/forfeited               | (740)                               | \$ 13.51                                 |   |   |
| Outstanding options at December 31, 2014 | 2,892,717                           | \$ 26.65                                 | 5.18  | \$ 65,809                                     |
| Exercisable options at December 31, 2014 | 1,238,257                           | \$ 20.02                                 | 3.94  | \$ 36,385                                     |

|  | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in 000's) |
|--|-------------------------------------|--|---|---|
| Outstanding options at January 1, 2013 | 2,945,204                           | \$ 22.22                                 |   |   |
| Options granted                        | 632,700                             | \$ 35.67                                 |   |   |
| Special dividend*                      | 272                                 | \$ 16.38                                 |   |   |
| Options exercised                      | (935,692)                           | \$ 17.40                                 |   | \$ 22,422                                     |
| Options canceled/forfeited             | (47,400)                            | \$ 24.86                                 |   |   |

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|  |           |          |      |           |
|--|-----------|----------|------|-----------|
| Outstanding options at December 31, 2013 | 2,595,084 | \$ 26.04 | 5.56 | \$ 58,790 |
| Exercisable options at December 31, 2013 | 934,544   | \$ 20.36 | 4.28 | \$ 26,474 |

|  | 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, 2012   | 2,561,732                           | \$ 21.62                                 |   |   |
| Options granted                          | 669,800                             | \$ 31.71                                 |   |   |
| Special dividend*                        | 2,172                               | \$ 15.39                                 |   |   |
| Options exercised                        | (282,260)                           | \$ 19.03                                 |   | \$ 4,712                                      |
| Options canceled/forfeited               | (6,240)                             | \$ 20.42                                 |   |   |
| Outstanding options at December 31, 2012 | 2,945,204                           | \$ 22.22                                 | 5.43  | \$ 29,865                                     |
| Exercisable options at December 31, 2012 | 1,362,184                           | \$ 18.29                                 | 4.27  | \$ 19,135                                     |

\*An adjustment was made to the exercise price and number of ISO options outstanding for the special cash dividends paid during December 2014, 2013 and 2012. "Special dividend" represents the incremental options issued as a result of this adjustment.

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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.

In 2014, 512,000 options were granted with an average exercise price of \$40.46 and an average fair value of \$7.89. Of these grants, 369,500 were granted at the board meeting in May with a calculated fair value of \$7.71. We recognized \$3.9 million of expense during 2014 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$1.4 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.8 million, which will be recognized over the remainder of the vesting period.

In 2013, 632,700 options were granted with an average exercise price of \$35.67 and an average fair value of \$6.88. Of these grants, 472,700 were granted at the board meeting in May with a calculated fair value of \$6.47. We recognized \$3.8 million of expense during 2013 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$1.3 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.5 million, which will be recognized over the remainder of the vesting period.

In 2012, 669,800 options were granted with an average exercise price of \$31.71 and an average fair value of \$6.55. Of these grants, 437,800 were granted at the board meeting in May with a calculated fair value of \$6.54. We recognized \$3.6 million of expense during 2012 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$1.3 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.3 million, which will be recognized over the remainder of the vesting period.

The fair value of options were estimated using a Black-Scholes based option pricing model with the following weighted-average grant-date assumptions and weighted average fair values as of December 31:

|                                       | 2014       | 2013       | 2012       |
|---------------------------------------|------------|------------|------------|
| Weighted-average fair value of grants | \$ 7.89    | \$ 6.88    | \$ 6.55    |
| Risk-free interest rates              | 1.70 %     | 0.87 %     | 0.90 %     |
| Dividend yield                        | 1.94 %     | 2.00 %     | 1.93 %     |
| Expected volatility                   | 23.17 %    | 25.40 %    | 25.62 %    |
| Expected option life                  | 5.19 years | 5.26 years | 5.43 years |



The risk-free rate was determined based on U.S. treasury yields that most closely approximated the option's expected life. The dividend yield was calculated based on the average annualized dividends paid during the most recent five-year period, exclusive of special dividends. In 2014, the expected volatility was calculated based on the median of the rolling volatilities for the expected life of the options. In 2013 and 2012, expected volatility was calculated based on the mean reversion of RLI's stock. 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.

In 2013 and 2014, each director received \$10,000 worth of restricted common shares as part of annual director compensation. The shares were issued from the LTIP during the first quarter of each year. The shares were directly owned by each director on the date of issuance and included a one-year restriction on the sale or transfer of such shares. In the first quarter of 2014, we issued a total of 2,097 restricted shares and recognized \$0.1 million of compensation expense. In the first quarter of 2013, we issued a total of 2,320 restricted shares and recognized \$0.1 million of compensation expense. This restricted share program was terminated in 2014.

## 9. STATUTORY INFORMATION AND DIVIDEND RESTRICTIONS

The statutory financial statements of our four insurance companies are presented on the basis of accounting practices prescribed or permitted by the Illinois Department of Insurance, which has adopted the NAIC statutory accounting practices as the basis of its statutory accounting practices. We do not use any permitted statutory accounting practices that differ from NAIC prescribed statutory accounting practices. In converting from statutory to GAAP, typical adjustments include deferral of policy acquisition costs, the inclusion of statutory non-admitted assets and the inclusion of net unrealized holding gains or losses in shareholders' equity relating to fixed maturities.

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The NAIC has RBC requirements that require insurance companies to calculate and report information under a risk-based formula, which measures statutory capital and surplus needs based upon a regulatory definition of risk relative to the company's balance sheet and mix of products. As of December 31, 2014, each of our insurance subsidiaries had an RBC amount in excess of the authorized control level RBC, as defined by the NAIC. RLI Insurance Company (RLI Ins.), our principal insurance company subsidiary, had an authorized control level RBC of \$118.4 million, \$90.6 million and \$90.4 million as of December 31, 2014, 2013 and 2012, respectively, compared to actual statutory capital and surplus of \$849.3 million, \$859.2 million and \$684.1 million, respectively, for these same periods.

Year-end statutory surplus for 2014 presented in the table below includes \$86.1 million of RLI stock (cost basis of \$64.6 million) held by Mt. Hawley Insurance Company, compared to \$64.0 million and \$9.1 million in 2013 and 2012, respectively. The Securities Valuation Office provides specific guidance for valuing this investment, which is eliminated in our GAAP consolidated financial statements.

The following table includes selected information for our insurance subsidiaries for the year ending and as of December 31:

| (in thousands)                           | 2014       | 2013       | 2012       |
|--|------------|------------|------------|
| Consolidated net income, statutory basis | \$ 176,664 | \$ 122,550 | \$ 125,672 |
| Consolidated surplus, statutory basis    | \$ 849,297 | \$ 859,221 | \$ 684,072 |

As discussed in note 1.A., 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 December 31, 2014, our holding company had \$845.1 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 \$46.7 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. In 2014, 2013 and 2012, our principal insurance subsidiary paid ordinary dividends totaling \$185.0 million, \$40.0 million and \$13.0 million, respectively, to RLI Corp. Any dividend distribution in excess of the ordinary dividend limits is deemed extraordinary and requires prior approval from the Illinois Department of Insurance. While no extraordinary dividends were paid in 2014 or 2013, our principal insurance subsidiary sought and received regulatory approval in 2012, prior to the payment of extraordinary dividends totaling \$125.0 million. As of December 31, 2014, \$53.4 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.

#### 10. COMMITMENTS AND CONTINGENT LIABILITIES

We are party to numerous claims, losses and litigation matters that arise in the normal course of our business. Many of such claims, losses or litigation matters involve claims under policies that we underwrite as an insurer. We believe that the resolution of these claims and losses will not have a material adverse effect on our financial condition, results of operations or cash flows. We are also involved in various other legal proceedings and litigation unrelated to our insurance business that arise in the ordinary course of business operations. Management believes that any liabilities that may arise as a result of these legal matters will not have a material adverse effect on our financial condition or results of operations.

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We have operating lease obligations for regional office facilities. These leases expire in various years through 2023. Expenses associated with these leases totaled \$5.8 million in 2014, \$5.7 million in 2013 and \$5.4 million in 2012. Minimum future rental payments under non-cancellable leases are as follows:

|                                      |           |
|--------------------------------------|-----------|
| (in thousands)                       |           |
| 2015                                 | \$ 4,810  |
| 2016                                 | 3,808     |
| 2017                                 | 3,007     |
| 2018                                 | 2,167     |
| 2019                                 | 1,510     |
| 2020-2023                            | 4,621     |
| Total minimum future rental payments | \$ 19,923 |

## 11. OPERATING SEGMENT INFORMATION

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

Our property segment is comprised primarily of commercial fire, earthquake, difference in conditions, marine, facultative and treaty reinsurance, including crop, and select personal lines policies, including recreational vehicle insurance and Hawaii homeowners coverages. 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 through extensive use of computer-assisted modeling techniques. These techniques 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 Federal Government reinsurance program that provides stop loss protection inuring to our benefit.

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

Net investment income is the by-product of the interest and dividend income streams from our investments in fixed income and equity securities. Interest and general corporate expenses include the cost of debt and other director and shareholder relations costs incurred for the benefit of the corporation, but not attributable to the operations of our insurance segments. Investee earnings represent our share in Maui Jim and Prime earnings. We own 40 percent of Maui Jim, a privately held company which operates in the sunglass and optical goods industries, and 20 percent of Prime, a privately-held excess and surplus lines insurance company which specializes in hard-to-place risks. Our investment in Maui Jim, which is carried at the holding company, is unrelated to our core insurance operations.

The following table summarizes our segment data based on the internal structure and reporting of information as it is used by management. The net earnings of each segment are before taxes and include revenues (if applicable), direct product or segment costs (such as commissions and claims costs), as well as allocated support costs from various support departments. While

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depreciation and amortization charges have been included in these measures via our expense allocation system, the related assets are not allocated for management use and, therefore, are not included in this schedule.

## REVENUES

| (in thousands)                     | 2014       | 2013       | 2012       |
|------------------------------------|------------|------------|------------|
| Casualty                           | \$ 382,105 | \$ 324,022 | \$ 267,697 |
| Property                           | 197,776    | 200,141    | 202,402    |
| Surety                             | 107,494    | 106,639    | 106,472    |
| Segment totals before income taxes | \$ 687,375 | \$ 630,802 | \$ 576,571 |
| Net investment income              | 55,608     | 52,763     | 58,831     |
| Net realized gains                 | 32,182     | 22,036     | 25,372     |
| Total                              | \$ 775,165 | \$ 705,601 | \$ 660,774 |

## INSURANCE EXPENSES

| (in thousands)                     | 2014       | 2013       | 2012       |
|------------------------------------|------------|------------|------------|
| Loss and settlement expenses:      |            |            |            |
| Casualty                           | \$ 199,133 | \$ 148,860 | \$ 144,106 |
| Property                           | 89,589     | 96,271     | 115,707    |
| Surety                             | 7,887      | 14,670     | 11,832     |
| Segment totals before income taxes | \$ 296,609 | \$ 259,801 | \$ 271,645 |
| Policy acquisition costs:          |            |            |            |
| Casualty                           | \$ 108,747 | \$ 93,463  | \$ 76,765  |
| Property                           | 58,646     | 58,650     | 60,070     |
| Surety                             | 61,890     | 58,538     | 59,527     |
| Segment totals before income taxes | \$ 229,283 | \$ 210,651 | \$ 196,362 |
| Other insurance expenses:          |            |            |            |
| Casualty                           | \$ 28,284  | \$ 26,107  | \$ 21,387  |
| Property                           | 16,623     | 17,616     | 14,933     |
| Surety                             | 9,557      | 9,834      | 8,651      |
| Segment totals before income taxes | \$ 54,464  | \$ 53,557  | \$ 44,971  |
| Total                              | \$ 580,356 | \$ 524,009 | \$ 512,978 |

## NET EARNINGS (LOSSES)

| (in thousands)          | 2014       | 2013       | 2012      |
|-------------------------|------------|------------|-----------|
| Casualty                | \$ 45,941  | \$ 55,592  | \$ 25,439 |
| Property                | 32,918     | 27,604     | 11,692    |
| Surety                  | 28,160     | 23,597     | 26,462    |
| Net underwriting income | \$ 107,019 | \$ 106,793 | \$ 63,593 |

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|  |            |            |            |
|--|------------|------------|------------|
| Net investment income                          | 55,608     | 52,763     | 58,831     |
| Net realized gains                             | 32,182     | 22,036     | 25,372     |
| General corporate expense and interest on debt | (17,660)   | (16,841)   | (13,917)   |
| Equity in earnings of unconsolidated investees | 12,338     | 10,915     | 8,853      |
| Total earnings before incomes taxes            | \$ 189,487 | \$ 175,666 | \$ 142,732 |
| Income taxes                                   | \$ 54,042  | \$ 49,411  | \$ 39,386  |
| Total  | \$ 135,445 | \$ 126,255 | \$ 103,346 |

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

| NET PREMIUMS EARNED<br>(in thousands) | Year ended December 31, |            |            |
|---------------------------------------|-------------------------|------------|------------|
|                                       | 2014                    | 2013       | 2012       |
| <b>CASUALTY</b>                       |                         |            |            |
| Commercial and personal umbrella      | \$ 100,420              | \$ 85,532  | \$ 68,287  |
| General liability                     | 80,820                  | 81,427     | 84,985     |
| Commercial transportation             | 58,911                  | 50,287     | 34,701     |
| Professional services                 | 58,327                  | 42,063     | 28,018     |
| P&C package business                  | 35,371                  | 30,603     | 28,497     |
| Executive products                    | 18,915                  | 19,123     | 17,198     |
| Medical professional liability        | 15,943                  | 8,626      | 25         |
| Other casualty                        | 13,398                  | 6,361      | 5,986      |
| Total                                 | \$ 382,105              | \$ 324,022 | \$ 267,697 |
| <b>PROPERTY</b>                       |                         |            |            |
| Commercial property                   | \$ 80,719               | \$ 76,939  | \$ 74,197  |
| Marine                                | 49,235                  | 57,122     | 56,367     |
| Crop reinsurance                      | 28,293                  | 31,421     | 24,506     |
| Specialty personal                    | 26,627                  | 16,308     | 12,022     |
| Property reinsurance                  | 12,756                  | 15,770     | 27,021     |
| Other property                        | 146                     | 2,581      | 8,289      |
| Total                                 | \$ 197,776              | \$ 200,141 | \$ 202,402 |
| <b>SURETY</b>                         |                         |            |            |
| Miscellaneous                         | \$ 39,026               | \$ 38,131  | \$ 39,299  |
| Contract                              | 26,592                  | 27,176     | 26,329     |
| Commercial                            | 25,778                  | 23,133     | 22,107     |
| Oil and gas                           | 16,098                  | 18,199     | 18,737     |
| Total                                 | \$ 107,494              | \$ 106,639 | \$ 106,472 |
| Grand total                           | \$ 687,375              | \$ 630,802 | \$ 576,571 |

## 12. UNAUDITED INTERIM FINANCIAL INFORMATION

Selected quarterly information is as follows:



| (in thousands, except per share data) | First      | Second     | Third      | Fourth     | Year       |
|---------------------------------------|------------|------------|------------|------------|------------|
| 2014                                  |            |            |            |            |            |
| Net premiums earned                   | \$ 161,132 | \$ 168,604 | \$ 177,747 | \$ 179,892 | \$ 687,375 |
| Net investment income                 | 13,582     | 13,982     | 14,200     | 13,844     | 55,608     |
| Net realized investment gains         | 6,501      | 10,431     | 5,708      | 9,542      | 32,182     |
| Earnings before income taxes          | 41,991     | 52,423     | 48,594     | 46,479     | 189,487    |
| Net earnings                          | 28,969     | 35,725     | 33,254     | 37,497     | 135,445    |
| Basic earnings per share(1)           | \$ 0.67    | \$ 0.83    | \$ 0.77    | \$ 0.87    | \$ 3.15    |
| Diluted earnings per share(1)         | \$ 0.66    | \$ 0.82    | \$ 0.76    | \$ 0.85    | \$ 3.09    |
| 2013                                  |            |            |            |            |            |
| Net premiums earned                   | \$ 144,151 | \$ 154,553 | \$ 163,702 | \$ 168,396 | \$ 630,802 |
| Net investment income                 | 12,886     | 12,847     | 13,598     | 13,432     | 52,763     |
| Net realized investment gains         | 3,684      | 3,742      | 10,999     | 3,611      | 22,036     |
| Earnings before income taxes          | 35,969     | 43,576     | 55,309     | 40,812     | 175,666    |
| Net earnings                          | 24,847     | 29,902     | 37,647     | 33,859     | 126,255    |
| Basic earnings per share(1)           | \$ 0.58    | \$ 0.70    | \$ 0.88    | \$ 0.79    | \$ 2.95    |
| Diluted earnings per share(1)         | \$ 0.57    | \$ 0.69    | \$ 0.86    | \$ 0.77    | \$ 2.90    |

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(1) Since the weighted-average shares for the quarters are calculated independently of the weighted-average shares for the year, quarterly earnings per share may not total to annual earnings per share.

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13. ACQUISITIONS

On February 5, 2014, we invested \$5.3 million for a 20 percent equity ownership interest in Prime, an Illinois domiciled insurance carrier based in Salt Lake City, Utah. Prime is a privately-held excess and surplus lines insurance company that distributes its products through a network of wholesale brokers and specializes 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 during 2014. Additionally, we entered into a 25 percent quota share reinsurance treaty with Prime, effective January 1, 2014, which contributed \$10.2 million of gross premiums written and \$5.3 million of net premiums earned during the year.

On November 2, 2012, we acquired Rockbridge, a Houston-based managing general agency. Rockbridge specializes in medical professional liability insurance in the excess and surplus markets. Coverage is offered to individual physicians and physician groups in all 50 states through a network of retail and wholesale brokers. Total consideration for the acquisition was \$16.7 million, which included \$15.5 million of cash paid at acquisition, and \$1.2 million associated with the present value of a contingent earn-out agreement. The earn-out is subject to the achievement of certain loss ratio targets and may be adjusted, either upward or downward, in future periods based on actual performance achieved. As of December 31, 2014, the recorded value of the contingent earn-out agreement was \$1.0 million. Rockbridge contributed \$15.1 million and \$16.7 million of gross premiums written during 2014 and 2013, respectively, and \$15.9 million and \$8.6 million of net premiums earned over the same periods.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of RLI Corp.:

We have audited the accompanying consolidated balance sheets of RLI Corp. and subsidiaries as of December 31, 2014 and 2013, and the related consolidated statements of earnings and comprehensive earnings, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2014. In connection with our audits of the consolidated financial statements, we have also audited financial statement schedules I – IV. We also have audited RLI Corp.'s internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control — Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). RLI Corp.'s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report on Controls and Procedures. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on RLI Corp.'s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of RLI Corp. and subsidiaries as of December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements, taken as a whole, present fairly, in all material respects, the information set forth therein. In our opinion, RLI Corp. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control — Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ KPMG LLP

Chicago, Illinois  
February 26, 2015

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

There were no changes in accountants or disagreements with accountants on any matters of accounting principles or practices or financial statement disclosure.

Item 9A. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of December 31, 2014.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in Internal Control — Integrated Framework (2013), our management concluded that our internal control over financial reporting was effective as of December 31, 2014.

Our internal control over financial reporting as of December 31, 2014 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report on page 103 of this report.

There was no change in our internal control over financial reporting during our fourth fiscal quarter ended December 31, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None

PART III

Items 10 to 14.

Items 10 through 14 (inclusive) of this Part III are not included herein because the Company will file a definitive Proxy Statement with the SEC that will include the information required by such Items, and such information is incorporated herein by reference. The Company's Proxy Statement will be filed with the SEC and delivered to stockholders in connection with the Annual Meeting of Shareholders to be held on May 7, 2015, and the information under the following captions is included in such incorporation by reference: "Share Ownership of Certain Beneficial Owners," "Board Meetings and Compensation," "Compensation Discussion & Analysis," "Executive Compensation," "Equity Compensation Plan Information," "Executive Management," "Corporate Governance and Board Matters," "Audit Committee Report" and "Proposal Two: Ratification of Selection of Independent Registered Public Accounting Firm — Fees Paid to the Independent Registered Public Accounting Firm."

PART IV

Item 15. Exhibits and Financial Statement Schedules

- (a) (1-2) See Item 8 for Consolidated Financial Statements included in this report.
- (3) Exhibits. See Exhibit Index on pages 116-117.
- (b) Exhibits. See Exhibit Index on pages 116-117.
- (c) Financial Statement Schedules. See Index to Financial Statement Schedules on page 106.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

(Registrant)

By: /s/ Thomas L. Brown  
Thomas L. Brown  
Vice President, Chief Financial Officer

Date: February 26, 2015

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Jonathan E. Michael  
Jonathan E. Michael, Chairman & CEO  
(Principal Executive Officer)

Date: February 26, 2015

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

Date: February 26, 2015

By: /s/ Kaj Ahlmann  
Kaj Ahlmann, Director

Date: February 26, 2015

By: /s/ Charles M. Linke  
Charles M. Linke, Director

Date: February 26, 2015

By: /s/ Barbara R. Allen  
Barbara R. Allen, Director

Date: February 26, 2015

By: /s/ F. Lynn McPheeters  
F. Lynn McPheeters, Director

Date: February 26, 2015

By: /s/ Michael E. Angelina  
Michael E. Angelina, Director

Date: February 26, 2015

By: /s/ Jonathan E. Michael  
Jonathan E. Michael, Director

Date: February 26, 2015

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By: /s/ John T. Baily  
John T. Baily, Director

By: /s/ James J. Scanlan  
James J. Scanlan, Director

Date: February 26, 2015

Date: February 26, 2015

By: /s/ Jordan W. Graham  
Jordan W. Graham, Director

By: /s/ Michael J. Stone  
Michael J. Stone, Director

Date: February 26, 2015

Date: February 26, 2015

By: /s/ Gerald I. Lenrow  
Gerald I. Lenrow, Director

By: /s/ Robert O. Viets  
Robert O. Viets, Director

Date: February 26, 2015

Date: February 26, 2015

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INDEX TO FINANCIAL STATEMENT SCHEDULES

Reference (Page)  
Data Submitted Herewith:

Schedules:

I. Summary of Investments  
- Other than Investments  
in Related Parties at  
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II. Condensed Financial  
Information of Registrant,  
as of and for the three  
years ended December 31,  
2014.

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III. Supplementary  
Insurance Information, as  
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ended December 31,  
2014.

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three years ended  
December 31, 2014.

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V. Valuation and  
Qualifying Accounts for  
the three years ended  
December 31, 2014.

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VI. Supplementary  
Information Concerning  
Property-Casualty  
Insurance Operations for  
the three years ended  
December 31, 2014.

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Schedules other than those listed are omitted for the reason that they are not required, are not applicable or that equivalent information has been included in the financial statements, and notes thereto, or elsewhere herein.



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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE I—SUMMARY OF INVESTMENTS—OTHER THAN INVESTMENTS

## IN RELATED PARTIES

December 31, 2014

| Column A                              | Column B     | Column C     | Column D          |
|---------------------------------------|--------------|--------------|-------------------|
| (in thousands)                        |              |              | Amount at         |
| Type of Investment                    | Cost (1)     | Fair Value   | which shown in    |
| Fixed maturities:                     |              |              | the balance sheet |
| Bonds:                                |              |              |                   |
| Available-for-sale                    |              |              |                   |
| U.S. Government                       | \$ 33,668    | \$ 33,788    | \$ 33,788         |
| U.S. Agency                           | 6,385        | 6,747        | 6,747             |
| Non-U.S. Government & Agency          | 9,862        | 10,665       | 10,665            |
| Mtge/ABS/CMBS*                        | 390,337      | 399,772      | 399,772           |
| Corporate                             | 543,183      | 562,690      | 562,690           |
| Municipal                             | 464,769      | 481,425      | 481,425           |
| Total available-for-sale              | \$ 1,448,204 | \$ 1,495,087 | \$ 1,495,087      |
| Held-to-maturity                      | \$ —         | \$ —         | \$ —              |
| Trading                               | —            | —            | —                 |
| Total fixed maturities                | \$ 1,448,204 | \$ 1,495,087 | \$ 1,495,087      |
| Equity securities, available-for-sale |              |              |                   |
| Common stock                          |              |              |                   |
| Ind Misc & all other                  | \$ 145,282   | \$ 320,786   | \$ 320,786        |
| ETFs (Ind/misc)                       | 48,253       | 89,856       | 89,856            |
| Total equity securities               | \$ 193,535   | \$ 410,642   | \$ 410,642        |
| Cash & short-term investments         | \$ 46,959    | \$ 46,959    | \$ 46,959         |
| Other invested assets                 | 11,597       | 11,597       | 11,597            |
| Total investments and cash            | \$ 1,700,295 | \$ 1,964,285 | \$ 1,964,285      |

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

Note: See notes 1E and 2 of Notes to Consolidated Financial Statements. See also the accompanying report of independent registered public accounting firm on page 103 of this report.

- (1) Original cost of equity securities and, as to fixed maturities, original cost reduced by repayments and adjusted for amortization of premiums or accrual of discounts.

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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE II—CONDENSED FINANCIAL INFORMATION OF REGISTRANT

## (PARENT COMPANY)

## CONDENSED BALANCE SHEETS

December 31,

| (in thousands, except share data)  | 2014         | 2013       |
|--|--------------|------------|
| <b>ASSETS</b>  |              |            |
| Cash   | \$ 374       | \$ 181     |
| Short-term investments, at cost which approximates fair value  | 177          | 13,394     |
| Accounts receivable, affiliates  | 3,803        | 2,350      |
| Investments in subsidiaries, at equity value   | 903,738      | 905,620    |
| Investments in unconsolidated investee, at equity value  | 54,316       | 49,793     |
| Fixed income:  |              |            |
| Available-for-sale, at fair value (amortized cost - \$46,226 in 2014 and \$18,839 in 2013)   | 46,136       | 18,447     |
| Property and equipment, at cost, net of accumulated depreciation of \$528 in 2014 and \$312 in 2013  | 3,208        | 3,446      |
| Income taxes receivable - current  | 463          | 493        |
| Deferred debt costs  | 1,258        | 1,398      |
| Other assets   | 681          | 190        |
| Total assets   | \$ 1,014,154 | \$ 995,312 |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |              |            |
| Liabilities:   |              |            |
| Income taxes - deferred  | \$ 16,372    | \$ 14,485  |
| Bonds payable, long-term debt  | 149,625      | 149,582    |
| Interest payable, long-term debt   | 2,153        | 1,808      |
| Other liabilities  | 942          | 471        |
| Total liabilities  | \$ 169,092   | \$ 166,346 |
| Shareholders' equity:  |              |            |
| Common stock (\$1 par value, authorized 100,000,000 shares, issued 66,032,929 shares in 2014 and 65,912,638 shares in 2013, and outstanding 43,102,715 shares in | \$ 66,033    | \$ 65,913  |

|  |              |            |
|--|--------------|------------|
| 2014 and 42,982,424 shares in 2013)                          |              |            |
| Paid in capital  | 213,737      | 208,705    |
| Accumulated other comprehensive earnings, net of tax         | 171,383      | 136,027    |
| Retained earnings  | 786,908      | 811,320    |
| Deferred compensation  | 13,769       | 11,562     |
| Treasury shares at cost (22,930,214 shares in 2014 and 2013) | (406,768)    | (404,561)  |
| Total shareholders' equity                                   | \$ 845,062   | \$ 828,966 |
| Total liabilities and shareholders' equity                   | \$ 1,014,154 | \$ 995,312 |

See Notes to Consolidated Financial Statements. See also the accompanying report of independent registered public accounting firm on page 103 of this report.

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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE II—CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(PARENT COMPANY)—(continued)

## CONDENSED STATEMENTS OF EARNINGS AND COMPREHENSIVE EARNINGS

Years ended December 31,

| (in thousands)  | 2014       | 2013       | 2012       |
|---|------------|------------|------------|
| Net investment income   | \$ 663     | \$ 652     | \$ 837     |
| Net realized investment gains (losses)                                  | 271        | (850)      | (2,834)    |
| Equity in earnings of unconsolidated investees                          | 12,009     | 10,915     | 8,853      |
| Selling, general and administrative expenses                            | (10,222)   | (8,746)    | (7,867)    |
| Interest expense on debt  | (7,438)    | (8,095)    | (6,050)    |
| Loss before income taxes  | \$ (4,717) | \$ (6,124) | \$ (7,061) |
| Income tax benefit  | (7,959)    | (11,946)   | (8,071)    |
| Net earnings before equity in net earnings of subsidiaries              | \$ 3,242   | \$ 5,822   | \$ 1,010   |
| Equity in net earnings of subsidiaries                                  | 132,203    | 120,433    | 102,336    |
| Net earnings  | \$ 135,445 | \$ 126,255 | \$ 103,346 |
| Other comprehensive income (loss), net of tax                           |            |            |            |
| Unrealized gains (losses) on securities:                                |            |            |            |
| Unrealized holding gains (losses) arising during the period             | \$ 372     | \$ (665)   | \$ 807     |
| Less: reclassification adjustment for gains included in net earnings    | (176)      | —          | (70)       |
| Other comprehensive income (loss) - parent only                         | \$ 196     | \$ (665)   | \$ 737     |
| Equity in other comprehensive earnings (loss) of subsidiaries/investees | 35,160     | (6,478)    | 25,108     |
| Other comprehensive earnings (loss)                                     | \$ 35,356  | \$ (7,143) | \$ 25,845  |
| Comprehensive earnings  | \$ 170,801 | \$ 119,112 | \$ 129,191 |

See Notes to Consolidated Financial Statements. See also the accompanying report of independent registered public accounting firm on page 103 of this report.

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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE II—CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(PARENT COMPANY)—(continued)

## CONDENSED STATEMENTS OF CASH FLOWS

Years ended December 31,

| (in thousands)  | 2014        | 2013        | 2012        |
|---|-------------|-------------|-------------|
| Cash flows from operating activities  |             |             |             |
| Earnings before equity in net earnings of subsidiaries                                      | \$ 3,242    | \$ 5,822    | \$ 1,010    |
| Adjustments to reconcile net losses to net cash provided by (used in) operating activities: |             |             |             |
| Net realized investment (gains) losses  | (271)       | 850         | 2,834       |
| Depreciation  | 238         | 90          | 30          |
| Other items, net  | 737         | (1,789)     | 852         |
| Change in:  |             |             |             |
| Affiliate balances receivable/payable   | (1,453)     | 1,349       | (10,383)    |
| Federal income taxes  | 3,982       | 5,288       | 3,964       |
| Stock option excess tax benefit   | (1,766)     | (6,310)     | (1,471)     |
| Changes in investment in unconsolidated investees:  |             |             |             |
| Undistributed earnings  | (12,009)    | (10,915)    | (8,853)     |
| Dividends received  | 6,600       | 13,200      | 6,600       |
| Net cash provided by (used in) operating activities   | \$ (700)    | \$ 7,585    | \$ (5,417)  |
| Cash flows from investing activities  |             |             |             |
| Purchase of:  |             |             |             |
| Fixed income, available-for-sale  | \$ (30,850) | \$ (99,982) | \$ (20,147) |
| Short-term investments, net   | —           | (12,963)    | —           |
| Property and equipment  | —           | (2,827)     | (250)       |
| Sale of:  |             |             |             |
| Fixed income, available-for-sale  | —           | —           | 7,938       |
| Short-term investments, net   | 13,217      | —           | 10,786      |
| Property and equipment  | —           | —           | 702         |
| Call or maturity of:  |             |             |             |
| Fixed income, available-for-sale  | 3,235       | 101,000     | 20,185      |
| Cash dividends received-subsiaries  | 185,000     | 40,000      | 138,000     |
| Net cash provided by investing activities   | \$ 170,602  | \$ 25,228   | \$ 157,214  |
| Cash flows from financing activities  |             |             |             |



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|  |              |             |              |
|--|--------------|-------------|--------------|
| Stock option excess tax benefit        | \$ 1,766     | \$ 6,310    | \$ 1,471     |
| Proceeds from stock option exercises   | 3,386        | 318         | 6,104        |
| Proceeds from issuance of senior notes | —            | 149,571     | —            |
| Payment on senior notes                | —            | (99,504)    | —            |
| Debt issue costs paid                  | —            | (1,437)     | —            |
| Cash dividends paid                    | (174,861)    | (101,913)   | (145,695)    |
| Net cash used in financing activities  | \$ (169,709) | \$ (46,655) | \$ (138,120) |
| Net (decrease) increase in cash        | \$ 193       | \$ (13,842) | \$ 13,677    |
| Cash at beginning of year              | 181          | 14,023      | 346          |
| Cash at end of year                    | \$ 374       | \$ 181      | \$ 14,023    |

Interest paid on outstanding debt amounted to \$7.0 million, \$8.4 million and \$6.0 million for 2014, 2013 and 2012, respectively. See Notes to Consolidated Financial Statements. See also the accompanying report of independent registered public accounting firm on page 103 of this report.

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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE III—SUPPLEMENTARY INSURANCE INFORMATION

As of and for the years ended December 31, 2014, 2013 and 2012

| (in thousands)<br>Segment       | Deferred policy<br>acquisition<br>costs | Unpaid losses<br>and settlement<br>expenses, gross | Unearned<br>premiums,<br>gross | Net<br>premiums<br>earned | Incurred losses<br>and settlement<br>expenses<br>current year |
|---------------------------------|---|--|--------------------------------|---------------------------|---|
| Year ended December 31,<br>2014 |   |  |                                |                           |   |
| Casualty segment                | \$ 31,334                               | \$ 964,699   | \$ 237,117                     | \$ 382,105                | \$ 251,958  |
| Property segment                | 13,827                                  | 120,858  | 94,092                         | 197,776                   | 90,712  |
| Surety segment                  | 19,962                                  | 35,483   | 70,203                         | 107,494                   | 18,781  |
| RLI Insurance Group             | \$ 65,123                               | \$ 1,121,040                                       | \$ 401,412                     | \$ 687,375                | \$ 361,451  |
| Year ended December 31,<br>2013 |   |  |                                |                           |   |
| Casualty segment                | \$ 28,553                               | \$ 947,677   | \$ 228,907                     | \$ 324,022                | \$ 210,665  |
| Property segment                | 14,275                                  | 146,122  | 97,116                         | 200,141                   | 103,544   |
| Surety segment                  | 18,680                                  | 35,634   | 66,058                         | 106,639                   | 18,073  |
| RLI Insurance Group             | \$ 61,508                               | \$ 1,129,433                                       | \$ 392,081                     | \$ 630,802                | \$ 332,282  |
| Year ended December 31,<br>2012 |   |  |                                |                           |   |
| Casualty segment                | \$ 19,673                               | \$ 955,730   | \$ 199,672                     | \$ 267,697                | \$ 184,555  |
| Property segment                | 14,523                                  | 169,250  | 103,854                        | 202,402                   | 132,507   |
| Surety segment                  | 18,148                                  | 33,503   | 65,820                         | 106,472                   | 19,166  |
| RLI Insurance Group             | \$ 52,344                               | \$ 1,158,483                                       | \$ 369,346                     | \$ 576,571                | \$ 336,228  |

NOTE 1: Investment income is not allocated to the segments, therefore net investment income has not been provided.

See the accompanying report of independent registered public accounting firm on page 103 of this report.

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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE III—SUPPLEMENTARY INSURANCE INFORMATION

(continued)

As of and for the years ended December 31, 2014, 2013 and 2012

| (in thousands)<br>Segment    | Incurred<br>losses and<br>settlement<br>expenses<br>prior year | Policy<br>acquisition<br>costs | Other<br>operating<br>expenses | Net<br>premiums<br>written |
|------------------------------|--|--------------------------------|--------------------------------|----------------------------|
| Year ended December 31, 2014 |  |                                |                                |                            |
| Casualty segment             | \$ (52,825)  | \$ 108,747                     | \$ 28,284                      | \$ 395,853                 |
| Property segment             | (1,123)  | 58,646                         | 16,623                         | 195,580                    |
| Surety segment               | (10,894)   | 61,890                         | 9,557                          | 111,719                    |
| RLI Insurance Group          | \$ (64,842)  | \$ 229,283                     | \$ 54,464                      | \$ 703,152                 |
| Year ended December 31, 2013 |  |                                |                                |                            |
| Casualty segment             | \$ (61,805)  | \$ 93,463                      | \$ 26,107                      | \$ 362,459                 |
| Property segment             | (7,273)  | 58,650                         | 17,616                         | 196,467                    |
| Surety segment               | (3,403)  | 58,538                         | 9,834                          | 107,396                    |
| RLI Insurance Group          | \$ (72,481)  | \$ 210,651                     | \$ 53,557                      | \$ 666,322                 |
| Year ended December 31, 2012 |  |                                |                                |                            |
| Casualty segment             | \$ (40,449)  | \$ 76,765                      | \$ 21,387                      | \$ 284,058                 |
| Property segment             | (16,800)   | 60,070                         | 14,933                         | 202,971                    |
| Surety segment               | (7,334)  | 59,527                         | 8,651                          | 106,057                    |
| RLI Insurance Group          | \$ (64,583)  | \$ 196,362                     | \$ 44,971                      | \$ 593,086                 |

See the accompanying report of independent registered public accounting firm on page 103 of this report.



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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE IV—REINSURANCE

Years ended December 31, 2014, 2013 and 2012

| (in thousands)<br>Segment              | Direct<br>amount | Ceded to<br>other<br>companies | Assumed<br>from other<br>companies | Net<br>amount | Percentage<br>of amount<br>assumed<br>to net |   |
|--|------------------|--------------------------------|------------------------------------|---------------|--|---|
| 2014                                   |                  |                                |                                    |               |  |   |
| Casualty                               | \$ 466,821       | \$ 92,532                      | \$ 7,816                           | \$ 382,105    | 2.0  | % |
| Property                               | 200,709          | 67,705                         | 64,772                             | 197,776       | 32.8   | % |
| Surety                                 | 114,110          | 6,906                          | 290                                | 107,494       | 0.3  | % |
| RLI Insurance Group premiums<br>earned | \$ 781,640       | \$ 167,143                     | \$ 72,878                          | \$ 687,375    | 10.6   | % |
| 2013                                   |                  |                                |                                    |               |  |   |
| Casualty                               | \$ 425,105       | \$ 103,696                     | \$ 2,613                           | \$ 324,022    | 0.8  | % |
| Property                               | 203,424          | 79,320                         | 76,037                             | 200,141       | 38.0   | % |
| Surety                                 | 113,040          | 6,642                          | 241                                | 106,639       | 0.2  | % |
| RLI Insurance Group premiums<br>earned | \$ 741,569       | \$ 189,658                     | \$ 78,891                          | \$ 630,802    | 12.5   | % |
| 2012                                   |                  |                                |                                    |               |  |   |
| Casualty                               | \$ 362,724       | \$ 96,039                      | \$ 1,012                           | \$ 267,697    | 0.4  | % |
| Property                               | 203,072          | 76,817                         | 76,147                             | 202,402       | 37.6   | % |
| Surety                                 | 113,328          | 7,294                          | 438                                | 106,472       | 0.4  | % |
| RLI Insurance Group premiums<br>earned | \$ 679,124       | \$ 180,150                     | \$ 77,597                          | \$ 576,571    | 13.5   | % |

See the accompanying report of independent registered public accounting firm on page 103 of this report.

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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE V—VALUATION AND QUALIFYING ACCOUNTS

Years ended December 31, 2014, 2013 and 2012

| (in thousands)                               | Balance<br>at beginning<br>of period | Amounts<br>charged<br>to expense | Amounts<br>recovered<br>(written off) | Balance<br>at end of<br>period |
|--|--------------------------------------|----------------------------------|---------------------------------------|--------------------------------|
| 2014 Allowance for uncollectible reinsurance | \$ 26,404                            | \$ —                             | \$ —                                  | \$ 26,404                      |
| 2013 Allowance for uncollectible reinsurance | \$ 26,404                            | \$ —                             | \$ —                                  | \$ 26,404                      |
| 2012 Allowance for uncollectible reinsurance | \$ 26,404                            | \$ —                             | \$ —                                  | \$ 26,404                      |

See the accompanying report of independent registered public accounting firm on page 103 of this report.



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## RLI CORP. AND SUBSIDIARIES

## SCHEDULE VI—SUPPLEMENTARY INFORMATION CONCERNING

## PROPERTY-CASUALTY INSURANCE OPERATIONS

Years ended December 31, 2014, 2013 and 2012

| (in thousands)<br>Affiliation with<br>Registrant (1) | Deferred policy<br>acquisition<br>costs | Claims and<br>claim adjustment<br>expense reserves | Unearned<br>premiums,<br>gross | Net<br>premiums<br>earned | Net<br>investment<br>income |
|--|---|--|--------------------------------|---------------------------|-----------------------------|
| 2014   | \$ 65,123                               | \$ 1,121,040                                       | \$ 401,412                     | \$ 687,375                | \$ 55,608                   |
| 2013   | \$ 61,508                               | \$ 1,129,433                                       | \$ 392,081                     | \$ 630,802                | \$ 52,763                   |
| 2012   | \$ 52,344                               | \$ 1,158,483                                       | \$ 369,346                     | \$ 576,571                | \$ 58,831                   |

|      | Claims and claim adjustment<br>expenses incurred related to: |               | Amortization<br>of deferred<br>acquisition costs | Paid claims and<br>claim adjustment<br>expenses | Net<br>premiums<br>written |
|------|--|---------------|--|---|----------------------------|
|      | Current<br>year  | Prior<br>year |  |   |                            |
| 2014 | \$ 361,451   | \$ (64,842)   | \$ 229,283                                       | \$ 285,184                                      | \$ 703,152                 |
| 2013 | \$ 332,282   | \$ (72,481)   | \$ 210,651                                       | \$ 283,891                                      | \$ 666,322                 |
| 2012 | \$ 336,228   | \$ (64,583)   | \$ 196,362                                       | \$ 269,955                                      | \$ 593,086                 |

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(1) Consolidated property-casualty insurance operations.

See the accompanying report of independent registered public accounting firm on page 103 of this report.

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## EXHIBIT INDEX

| Exhibit No. | Description of Document   | Reference (page)  |
|-------------|---|---|
| 3.1         | Amended and Restated Articles of Incorporation  | Incorporated by reference to the Company's Form 8 K filed May 8, 2009.  |
| 3.2         | Restated By-Laws  | Incorporated by reference to the Company's Form 8 K filed May 6, 2011.  |
| 4.1         | Senior Indenture  | Incorporated by reference to the Company's Form 8 K filed October 2, 2013.  |
| 10.1        | The RLI Corp. Directors' Irrevocable Trust Agreement*                                   | Incorporated by reference to the Company's Quarterly Form 10 Q for the Second Quarter ended June 30, 1993.                |
| 10.2        | RLI Corp. Nonemployee Directors' Deferred Compensation Plan, as amended*                | Incorporated by reference to the Company's Form 10 K filed February 25, 2009.   |
| 10.3        | RLI Corp. Executive Deferred Compensation Plan, as amended*                             | Incorporated by reference to the Company's Form 10 K filed February 25, 2009.   |
| 10.4        | Key Employee Excess Benefit Plan, as amended*   | Incorporated by reference to the Company's Form 10 K filed February 25, 2009.   |
| 10.5        | RLI Corp. Omnibus Stock Plan*   | Incorporated by reference to the Company's Registration Statement on Form S 8 filed on May 31, 2005, File No. 333-125354. |
| 10.6        | RLI Corp. Annual Incentive Compensation Plan, as amended*                               | Incorporated by reference to the Company's Form 10 K filed February 25, 2011.   |
| 10.7        | RLI Corp. Long-Term Incentive Plan*   | Incorporated by reference to the Company's Form 8-K filed on May 6, 2010.   |
| 10.8        | Market Value Potential (MVP), Executive Incentive Program Guideline*                    | Incorporated by reference to the Company's Form 10 K filed February 27, 2014.   |
| 10.9        | Credit Agreement (JP Morgan Chase Bank N.A.)  | Incorporated by reference to the Company's Form 8 K filed September 26, 2014.   |
| 10.10       | Advances, Collateral Pledge, and Security Agreement (Federal Home Loan Bank of Chicago) | Incorporated by reference to the Company's Form 8 K filed June 3, 2014.   |
| 11.0        | Statement re: computation of per share earnings   | Refer to Note 1.O., "Earnings per share," on page 75.   |

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\*Management contract or compensatory plan.

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EXHIBIT INDEX

| Exhibit No. | Description of Document  | Reference Page          |
|-------------|--|-------------------------|
| 21.1        | Subsidiaries of the Registrant   | Page 118                |
| 23.1        | Consent of KPMG LLP  | Page 119                |
| 31.1        | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  | Page 120                |
| 31.2        | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  | Page 121                |
| 32.1        | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Page 122                |
| 32.2        | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Page 123                |
| 101         | XBRL-Related Documents   | Attached as Exhibit 101 |