RLI CORP
Form 10-K
February 25, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2010

or

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

For the transition period from to

Commission File Number 001-09463

RLI CORP.

(Exact name of registrant as specified in its charter)

Illinois	**37-0889946**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

9025 North Lindbergh Drive, Peoria, Illinois	**61615**
(Address of principal executive offices)	(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	**Name of each exchange on which registered**
Common Stock $1.00 par value	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 x No o

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 o No x

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 x No o

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 x No o

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. x

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 x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The aggregate market value of the registrant s common stock held by non-affiliates of the Registrant as of June 30, 2010, based upon the closing sale price of the Common Stock on June 30, 2010 as reported on the New York Stock Exchange, was $910,921,846. 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 9, 2011 was 21,026,645.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the 2010 Financial Report to Shareholders for the year ended December 31, 2010, are incorporated by reference into Parts I and II of this document.

Portions of the Registrant s definitive Proxy Statement for the 2011 annual meeting of security holders to be held May 5, 2011, are incorporated herein by reference into Part III of this document.

Exhibit index is located on pages 61-62 of this document, which lists documents incorporated by reference herein.

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

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

We distribute our property and casualty insurance through our wholly-owned branch offices that market to wholesale producers. We also market certain coverages to retail producers from several of our casualty, surety and property operations. We produce a limited amount of business under agreements with managing general agents under the direction of our product vice presidents. The majority of business is marketed through our branch offices located throughout the United States.

For the year ended December 31, 2010, the following table provides the geographic distribution of our risks insured as represented by direct premiums earned for all coverages. For the year ended December 31, 2010, no other state accounted for 1.5 percent or more of total direct premiums earned for all coverages.

State		Direct Premiums Earned (in thousands)	Percent of Total
California	$	107,690	18.0%
New York		83,080	13.9%
Florida		72,956	12.2%
Texas		53,631	8.9%
New Jersey		23,620	3.9%
Illinois		18,153	3.0%
Louisiana		17,067	2.8%
Pennsylvania		15,536	2.6%
Hawaii		15,020	2.5%
Ohio		11,166	1.9%
Massachusetts		10,472	1.7%
Washington		10,455	1.7%
All Other		160,823	26.9%
Total direct premiums	$	599,669	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 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, through premium volume, 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 our audited consolidated financial statements included in our 2010 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

	Year Ended December 31,					
(in thousands)		2010		2009		2008
PREMIUMS WRITTEN						
Direct & Assumed	$	636,316	$	631,200	$	681,169
Reinsurance ceded		(151,176)		(161,284)		(167,713)
Net	$	485,140	$	469,916	$	513,456
PREMIUMS EARNED						
Direct & Assumed	$	647,306	$	654,323	$	701,042
Reinsurance ceded		(153,924)		(162,362)		(172,278)
Net	$	493,382	$	491,961	$	528,764

Specialty Insurance Market Overview

The specialty insurance market differs significantly from the standard market. In the standard 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 market counterparts, we manage these risks to achieve higher financial returns. To reach our financial and operational goals, we must have extensive knowledge and expertise in our markets. Most 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 excess and surplus insurance market, the specialty admitted insurance market and the specialty property reinsurance market.

Excess and Surplus Insurance Market

The excess and surplus market focuses on hard-to-place risks. Excess and surplus eligibility allows us to underwrite nonstandard market 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. In 2010, the excess and surplus market represented approximately $23 billion, or 5 percent, of the entire $478 billion domestic property and casualty industry, as measured by direct premiums written. Our excess and surplus operation wrote gross premiums of $232.4 million, or 36 percent, of our total gross premiums written.

Specialty Admitted Insurance Market

We also write business in the specialty admitted market. Most of these risks are unique and hard to place in the standard 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 2010, our specialty admitted operations wrote gross premiums of $355.9 million, representing approximately 56 percent of our total gross premiums written for the year.

Specialty Property Reinsurance Market

We write business in the specialty property reinsurance market. 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 client, another (re)insurance company. 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 2010, our specialty property reinsurance operations wrote gross written premiums of $48.0 million, representing about 8 percent of our total gross written premiums for the year.

Business Segment Overview

Our segment data is derived using the guidance set forth in FASB 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 our audited consolidated financial statements included in our 2010 Financial Report to Shareholders, attached as Exhibit 13 and incorporated by reference herein.

Casualty Segment

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. In 2009, we expanded into 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 $96.6 million, $115.4 million and $140.9 million, or 17 percent, 21 percent and 25 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Commercial and Personal Umbrella Liability

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. In 2010, we broadened eligibility guidelines and offered certain coverage enhancements in an effort to broaden our market reach. Net premiums earned from this business totaled $61.4 million, $62.4 million and $65.1 million, or 11 percent, 11 percent and 12 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Commercial Transportation

Our transportation insurance facility in Atlanta provides automobile liability and physical damage insurance to local, intermediate and long haul truckers, public transportation risks and equipment dealers, along with other types of specialty commercial automobile risks. We also offer incidental, related insurance coverages, including general liability, commercial umbrella and excess liability and motor truck cargo. The facility is staffed by highly experienced transportation underwriters who produce business through independent agents and brokers nationwide. Net premiums earned from this business totaled

$40.3 million, $42.2 million and $46.7 million, or 7 percent, 8 percent and 8 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Executive Products

We provide a variety of professional liability coverages, such as directors and officers (D&O) liability insurance, employment practices liability and other miscellaneous professional liability coverages, for a variety of low to moderate classes of risks. We tend to focus on smaller accounts, avoiding the large account sector which is generally more sensitive to price competition. Our target accounts include publicly traded companies with market capitalization below $5 billion (where we are writing part of the traditional D&O program), Side A coverage (where corporations cannot indemnify the individual D&Os), private companies, nonprofit organizations and sole-sponsored and multi-employer fiduciary liability accounts. Our primary focus for publicly traded companies is on providing Side A coverage. Additionally, we have had success rounding out our portfolio by writing more fiduciary liability coverage, primary and excess D&O coverage for private companies and non-profit organizations. In 2009, we began offering coverage for select first and third party cyber liability exposures. Net premiums earned from the executive products business totaled $15.8 million, $15.6 million and $13.8 million, or 3 percent, 3 percent and 2 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Specialty Program Business

We offer program business in a variety of areas, which are typically multiple coverages combined into a package or portfolio policy. Our program coverages include: commercial property, general liability, inland marine and crime. We rely primarily on program administrators as sources for this business. In October 2010, we began offering pet insurance for domesticated animals. Net premiums earned from the specialty program business totaled $7.2 million, $21.6 million and $38.3 million, or 1 percent, 7 percent and 6 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Other

We offer a variety of other smaller programs in our casualty segment, including in-home business and employer s excess indemnity. In February 2009, we began a professional liability for design professionals coverage targeting small to medium-size risks. More recently, we have expanded our product suite to these same customers by offering a full array of multi-peril package products including worker s compensation coverage. Net premiums earned from these lines totaled $9.8 million, $7.9 million and $8.6 million, or 2 percent, 1 percent and 2 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Property Segment

Commercial

Our commercial property coverage consists primarily of excess and surplus lines and specialty insurance such as fire, earthquake and difference in conditions, which can include earthquake, wind, flood and collapse coverages and inland marine. 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 commercial property business totaled $80.5 million, $81.8 million and $85.3 million, or 14 percent, 15 percent and 15 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Marine

Our marine coverages include cargo, hull and protection and indemnity (P&I), marine liability, as well as inland marine coverages including builders risks, contractors equipment and other floater type coverages. In March 2008, the marine division added a yacht program. In 2010, 2009 and 2008, marine net premiums earned totaled $48.0 million, $52.5 million and $48.2 million, or 8 percent, 10 percent and 9 percent of consolidated revenues, respectively.

Crop Reinsurance

In January 2010, we added crop reinsurance to the property segment as we entered into a two-year agreement to become a quota share reinsurer of Producers Agricultural Insurance Company (ProAg). ProAg is a crop insurance company located in Amarillo, Texas. Under this agreement, we will reinsure a portion of ProAg s multi-peril crop insurance (MPCI) and crop hail premium and exposure. Crop insurance is purchased by agricultural producers for protection against crop-related losses due to natural disasters and other perils. The MPCI program is a partnership with the U.S. Department of Agriculture

(USDA). Crop insurers such as ProAg also issue policies that cover revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects, and disease. The new crop reinsurance agreement added $27.1 million in net premiums earned in 2010, or 5 percent of consolidated revenues.

Property Reinsurance

We offer facultative and other treaty reinsurance. These products were launched in 2007 for facultative coverages and expanded to treaty reinsurance in 2009. The division underwrites property facultative reinsurance for insurance companies utilizing reinsurance intermediaries. The facultative unit specializes in underground mining, power generation, and other technical risks requiring underwriting expertise. Perils covered range from fire, mechanical breakdown, 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. During 2009, we began opportunistically writing select specialty property treaties on a proportional basis. 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. This expanded in the second quarter of 2010 to include industry loss warranty (ILW) treaties. Under the ILW treaties, we provide reinsurance coverage for windstorm losses if two loss triggers (an industry loss limit trigger and a retention trigger) are met. Net premiums earned from property reinsurance business totaled $9.9 million, $7.8 million and $1.6 million, or 2 percent, 1 percent and less than 1 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Other

We offer a variety of other smaller programs in our property segment, including a limited amount of homeowners and dwelling fire insurance in Hawaii. Net premiums earned from other property coverages totaled $16.1 million, $13.2 million and $11.8 million, or 3 percent, 2 percent and 2 percent of consolidated revenues for 2010, 2009 and 2008, respectively.

Surety Segment

Our surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical and refining industries. We offer miscellaneous bonds, including license and permit, notary and court bonds. In September 2008, we launched a fidelity division focusing on fidelity and crime coverage for commercial insureds and select financial institutions. These bonds are written through independent agencies as well as regional and national brokers. Net earned premium from the surety segment totaled $80.7 million, $71.6 million and $68.4 million, or 14 percent, 13 percent and 12 percent of consolidated revenues for 2010, 2009 and 2008, 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 more recently through e-commerce channels.

Brokers

The largest volume of broker-generated premium is in our commercial property, general liability, commercial surety, commercial umbrella, commercial automobile, and specialty facultative and treaty reinsurance coverages. This business is produced through wholesale, retail, and reinsurance brokers who are not affiliated with us.

Independent Agents

Our surety segment offers its business through a variety of independent agents. Additionally, we write program business, such as at-home business and personal umbrella, through independent agents. Homeowners and dwelling fire is produced through independent agents in Hawaii. Each of these programs involves 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 through our system.

Underwriting Agents

We contract with certain underwriting agencies who 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, at-home businesses, small commercial and personal umbrella risks surety bonding, and pet insurance. Our largest assumed reinsurance treaty is on a direct basis with ProAg.

Competition

Our specialty property and casualty insurance subsidiaries are part of an extremely 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 2,400 companies, both stock and mutual, actively market property and casualty coverages. Our primary competitors in our casualty segment are, among others, Ace, Arch, James River, Landmark, Navigators, USLI, Great West, Lancer, National Interstate, Chubb, Philadelphia, Great American, Travelers and CNA. Our primary competitors in our property segment are, among others, Ace, Lexington, Arch, Crum & Forster, Travelers and Markel. Our primary competitors in our surety segment are, among others, Ace, Arch, HCC, CNA, Safeco, North American Specialty, Travelers and Hartford. 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 into all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. In the casualty, property and surety areas, we have acquired experienced underwriting specialists in our branch and home offices. We have continued 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 new programs where the opportunity exists to provide needed insurance coverage with exceptional service on a profitable basis.

Financial Strength Ratings

A.M. Best ratings for the industry range from A++ (Superior) to F (In Liquidation) with some companies not being rated. Standard & Poor s ratings for the industry range from AAA (Extremely strong) to R (Regulatory Action). Moody s 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)

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 opini have achieved excellent overall performance when compared to the standards established by these firms 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 reviews 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 directed to the protection of investors.

At December 31, 2010, the following ratings were assigned to our insurance companies:

A.M. Best	
RLI Insurance, Mt. Hawley Insurance and RLI Indemnity (RLI Group)	A+, Superior
Standard & Poor s*	
RLI Insurance and Mt. Hawley Insurance	A+, Strong
Moody s	
RLI Insurance, Mt. Hawley Insurance and RLI Indemnity	A2, Good

* Standard & Poor s does not rate RLI Indemnity

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 May 2010, RLI Ins., Mt. Hawley Insurance Company and RLI Indemnity Company, collectively referred to as RLI Group, were assigned a financial size category of XI (adjusted policyholders surplus of between $750 million and $1 billion). As of December 31, 2010, the policyholders statutory surplus of RLI Group totaled $732.4 million. This would put the group in A.M. Best s financial size category X (adjusted policyholders surplus of between $500 million and $750 million).

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 $153.9 million, $162.4 million, and $172.3 million in 2010, 2009, and 2008, respectively. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. While reinsurance does not relieve us of our legal liability to our policyholders, we use reinsurance as an alternative to using our own capital to fund losses. 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 of and the 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 91 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.

The following table sets forth the 10 largest reinsurers in terms of amounts recoverable, net of collateral we are holding from such reinsurers, as of December 31, 2010. These all have financial strength ratings of A or better by A.M. Best and Standard and Poor s rating services. Also shown are the amounts of written premium ceded to these reinsurers during the calendar year 2010.

(dollars in thousands)	A.M. Best Rating	S & P Rating		Net Reinsurer Exposure as of 12/31/2010	Percent of Total		Ceded Premiums Written	Percent of Total
Munich Re America / HSB	A+	AA-	$	59,682	15.3%	$	18,929	12.5%
Endurance Re	A	A		53,992	13.9%		18,648	12.3%
Swiss Re / Westport Ins. Corp.	A	A+		35,059	9.0%		3,491	2.3%
Axis Re	A	A+		29,793	7.6%		8,810	5.8%
General Cologne Re	A++	AA+		28,071	7.2%		1,797	1.2%
Transatlantic Re	A	A+		24,314	6.2%		14,462	9.6%
Aspen UK Ltd.	A	A		22,381	5.7%		9,197	6.1%
Lloyds of London	A	A+		21,821	5.6%		14,652	9.7%
Berkley Insurance Co.	A+	A+		20,049	5.1%		7,432	4.9%
Toa-Re	A	A+		13,269	3.4%		4,245	2.8%
All other reinsurers				81,077	21.0%		49,513	32.8%
Total ceded exposure			$	389,508	100.0%	$	151,176	100.0%

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 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. Our property and surety treaties tend to include reinstatement provisions which require us, in certain circumstances, to pay reinstatement premiums after a loss has occurred in order to preserve coverage.

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

Product Line(s) Covered (in millions)	Contract Type	Renewal Date		First-Dollar Retention		Limit Purchased		Maximum Retention
General liability	Excess of Loss	1/1	$	0.5	$	4.5	$	1.4
Brokerage umbrella and excess	Quota Share/ Excess of Loss	1/1		N/A		10.0		1.5
Personal umbrella and eXS	Excess of Loss	1/1		1.0		5.0		1.75
Transportation	Excess of Loss/ Quota Share	1/1		0.5		4.5		0.5
Executive products	Quota Share	7/1		N/A		25.0		8.75
Design Professionals - liability	Quota Share	4/1		N/A		5.0		2.0
Design Professionals - workers compensation	Excess of Loss	11/1		1.0		9.0 per occurrence		1.0
Property	Excess of Loss	1/1		1.0		14.0		1.6
Marine	Excess of Loss	5/1		2.0		28.0		2.0
Surety	Excess of Loss	4/1		2.0		48.0		7.1
Fidelity	Quota Share	7/1		N/A		25.0		3.75

At each renewal, we consider plans to change the insurance coverage we offer, updated loss activity, the level of RLI Ins. s surplus, changes in our risk appetite, and the cost and availability of reinsurance treaties. In the last renewal cycle, we made several material changes to the coverage provided. We changed the contract type for brokerage umbrella and excess business from a variable quota share, which provides a different reinsurance limit depending on the amount of insurance limit provided, to a quota share. This increased our retention for some policies and decreased our retention on others. We also increased the reinsurance limit purchased for personal umbrella coverage from $4.5 million to $5.0 million. We increased our retention on the executive products and design professional treaties by $1.25 million and $0.5 million, respectively. The workers compensation treaty was a new purchase in 2010 to support our design professional business unit s expansion in offering package policies to their insureds. We increased property coverage from $9.0 million to $14.0 million and decreased the reinsurance limit purchased for marine from $39.0 million to $28.0 million. Marine and surety first-dollar retentions increased from $1.0 million to $2.0 million.

Property Reinsurance Catastrophe Coverage

Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our property segment. Catastrophes involve multiple claims and policyholders. Reinsurance limits purchased fluctuate due to changes in the number of policies 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 catastrophe lines of business. At high rates of return, we grow the book of business and may purchase additional reinsurance depending on our capital position. As the rate of return decreases, we shrink the book and may purchase less reinsurance to increase our return. Our reinsurance coverage for the last few years follows:

Catastrophe Coverages

(in millions)

	2011		2010		2009		2008	
	First-Dollar Retention	**Limit**	**First-Dollar Retention**	**Limit**	**First-Dollar Retention**	**Limit**	**First-Dollar Retention**	**Limit**
California Earthquake	$ 25	300	$ 50	325	$ 50	325	$ 50	350
Other Earthquake	25	325	25	350	25	350	25	375
Other Perils	25	225	25	150	25	150	25	175

These catastrophe limits are in addition to the per-occurrence coverage provided by facultative and other treaty coverages. We have participated in the catastrophe layers purchased by retaining a percentage of each layer throughout this period. Our participation has varied based on price and the amount of risk transferred by each layer.

Our property catastrophe 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 catastrophe modeling software to illustrate our net retention resulting from particular events that would generate the listed levels of gross losses:

Catastrophe - California Earthquake

(in millions)

	2010		2009		2008	
Projected	**Ceded**	**Net**	**Ceded**	**Net**	**Ceded**	**Net**

Gross Loss		Losses		Losses		Losses		Losses		Losses		Losses
$ 50	$	29	$	21	$	9	$	41	$	7	$	43
100		71		29		48		52		50		50
200		161		39		132		68		139		61
350		299		51		276		74		276		74

Catastrophe - Other (Earthquake outside of California, Wind, etc.)

(in millions)

	2010		2009		2008	
Projected Gross Loss	Ceded Losses	Net Losses	Ceded Losses	Net Losses	Ceded Losses	Net Losses
$ 25	$ 6	$ 19	$ 9	$ 16	$ 6	$ 19
50	17	33	27	23	29	21
100	56	44	68	32	73	27
150	99	51	108	42	117	33

Projected losses as of the end of each year presented above were estimated utilizing the current treaty structure in place at that time (January of each 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 shown. 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 to large events. The largest losses shown above are unlikely to occur based on the probability of those events 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 catastrophe reinsurance.

Our catastrophe program includes one prepaid reinstatement for the first two layers of coverage, up to $100 million, for a catastrophe other than California earthquake. If a loss does occur, reinstatement must be purchased for the remaining limits. For a California earthquake, there is a prepaid reinstatement for the $50.0 million excess $50.0 million layer (placed at 78 percent, 75 percent, and 77 percent for 2011, 2010, and 2009, respectively) and a reinstatement must be purchased for the remaining limits.

We continuously monitor and quantify our exposure to catastrophes, including earthquakes, hurricanes, terrorist acts and other catastrophic events. In the normal course of business, we manage our concentrations of exposures to catastrophic events, primarily by limiting concentrations of exposure 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 catastrophe exposure models and an internally developed analysis to assess each risk to ensure we include an appropriate charge for assumed catastrophe risks. Catastrophe 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 catastrophe-exposed business. From both perspectives, we consider the potential loss produced by individual events that represent moderate-to-high loss potential at varying return periods and magnitudes. In calculating potential losses, we select appropriate assumptions including, but not limited to, 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 catastrophe models, rating agency capital constraints, underwriting guidelines and coverages and internal preferences. Our risk tolerances for each type of catastrophe, 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 catastrophe 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 catastrophe reinsurance treaty purchased on January 1, 2011, there is a 99.6 percent likelihood that the loss will be less than 9.5 percent of policyholders surplus as of December 31, 2010.

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, 2010, 2009 and 2008:

			December 31,			
(dollars in thousands)		**2010**		**2009**		**2008**
Loss and Loss Adjustment						
Expense (LAE) payments (Cumulative)						
Gross	$	86,453	$	75,544	$	70,210

Ceded		(43,015)		(41,639)		(39,143)
Net	$	43,438	$	33,905	$	31,067
Unpaid losses and LAE at end of year						
Gross	$	72,243	$	68,198	$	65,583
Ceded		(36,895)		(20,142)		(20,407)
Net	$	35,348	$	48,056	$	45,176

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.

During 2010, we experienced elevated payment activity relative to previous years on both a direct and net basis. Most of this activity was driven by mass tort claim activity from the 1980s associated with Underwriter s Indemnity Company (UIC) which we purchased in 1999. The most significant claims from this book were settled in 2010. We recorded $3.9 million direct and $0.7 million net of incurred losses on these claims in 2010. The resulting payment served to decrease ending reserves. Additionally, there were significant payments associated with our assumed run-off book of reinsurance. Four asbestos claims had payments totaling $1.5 million gross and $1.2 million net. The significant increase in ceded reserves in 2010 was largely due to adjustments for a 2007 marine liability claim as well as the UIC mass tort claims.

During 2009, the increase in inception-to-date gross loss payments was significantly less than we experienced in 2008. Of particular note was a mass tort claim from accident year 2005 against an insured hotel involving carbon monoxide discharge. This resulted in payments of $1.6 million direct and $0.8 million net; approximately the same amounts as the case reserves established in 2008. Also, a marine liability claim from accident year 2007 involving a fuel spill resulted in payments of $0.3 million direct and net.

The increase in 2009 reserves over 2008 was driven primarily by claim activity from the 1980s associated with UIC. In recent years, we have had unexpected claim activity from this book of business, which caused us to add $4.7 million of both direct and net IBNR in 2009. Claim activity was lower in 2009 than in 2008, but we are still receiving new claim notifications.

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 such issues 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.

Losses and Settlement Expenses

Overview

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

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

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

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

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

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

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

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

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

All decisions regarding our best estimate of ultimate loss and LAE reserves are made by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at December 31, 2010, make a reasonable provision to meet our future obligations.

Net loss and loss adjustment reserves by product line at year-end 2010 and 2009 were as follows:

(as of December 31, in $ thousands)

	2010			2009		
Product Line	**Case**	**IBNR**	**Total**	**Case**	**IBNR**	**Total**
Casualty segment net loss and ALAE reserves						
Commercial umbrella	$ 3,608	$ 31,829	$ 35,437	$ 2,121	$ 19,621	$ 21,742
Personal umbrella	24,862	25,677	50,539	23,108	31,222	54,330
General liability	139,750	231,014	370,764	104,586	235,534	340,120
Transportation	49,033	7,654	56,687	50,964	11,070	62,034
Executive products	9,480	30,200	39,680	6,647	34,752	41,399
Other casualty	26,969	42,751	69,720	34,064	71,626	105,690
Property segment net loss and ALAE reserves						
Marine	23,986	30,079	54,065	25,820	26,282	52,102
Crop	15,439	4,067	19,506			
Assumed property	3,673	3,529	7,202	218	2,167	2,385
Other property	9,825	11,635	21,460	10,577	12,994	23,571
Surety segment net loss and ALAE reserves	5,964	18,398	24,362	4,374	18,869	23,243
Latent liability net loss and ALAE reserves	15,172	20,176	35,348	22,813	25,243	48,056
Total net loss and ALAE reserves	327,761	457,009	784,770	285,292	489,380	774,672
ULAE reserves		35,010	35,010		35,396	35,396
Total net loss and LAE reserves	$ 327,761	$ 492,019	$ 819,780	$ 285,292	$ 524,776	$ 810,068

Initial IBNR Generation Process

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

For most property products, we use an alternative method of determining an appropriate provision for initial IBNR. Since this segment is characterized by a shorter period of time between claim occurrence and claim settlement, the IBNR reserve is determined by an IBNR percentage applied to premium earned. The IBNR percentage is determined based on historical reserve patterns and is updated periodically. In addition, for assumed reinsurance, consideration is given to information provided by the ceding company. No deductions for paid or case reserves are made. This alternative method of determining initial IBNR reacts more rapidly to the actual loss emergence and is more appropriate for our property products where final claim resolution occurs 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 and price change and loss cost trends. The initial loss and ALAE ratios also reflect a provision for estimation risk. We consider estimation risk by segment and product line. A segment with greater overall volatility and uncertainty has greater estimation risk. Characteristics of segments and products with higher estimation risk include, but are not limited to, the following:

- Significant changes in underlying policy terms and conditions,

- A new business or one experiencing significant growth and/or high turnover,

- Small volume or lacking internal data requiring significant 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 or economic change.

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 catastrophe business (included below in Other Property) has significant variance in year-over-year results; however its reserving estimation risk is relatively moderate.

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 High severity Loss trend volatility Unforeseen tort potential Exposure changes/mix	High	High
Personal umbrella	Medium	Internal	Low frequency	Medium	Medium
General liability	Long	Internal	Exposure growth/mix Unforeseen tort potential	Medium	High