

RLI CORP  
Form 10-Q  
October 24, 2016  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

or

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

For the transition period from                      to

Commission File Number: 001-09463

RLI Corp.

(Exact name of registrant as specified in its charter)

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

(309) 692-1000

(Registrant's telephone number, including area code)

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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As of October 12, 2016, the number of shares outstanding of the registrant's Common Stock was 43,906,953.

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## RLI Corp. and Subsidiaries

## Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

| (in thousands, except per share data)                        | For the Three-Month Periods<br>Ended September 30, |            |
|--|--|------------|
|  | 2016   | 2015       |
| Net premiums earned  | \$ 183,595   | \$ 179,448 |
| Net investment income  | 13,504   | 13,964     |
| Net realized gains   | 9,347  | 7,534      |
| Other-than-temporary impairment (OTTI) losses on investments | (95)   | -          |
| Consolidated revenue   | \$ 206,351   | \$ 200,946 |
| Losses and settlement expenses                               | 97,892   | 73,051     |
| Policy acquisition costs                                     | 61,761   | 60,505     |
| Insurance operating expenses                                 | 13,338   | 12,299     |
| Interest expense on debt                                     | 1,857  | 1,857      |
| General corporate expenses                                   | 2,242  | 1,958      |
| Total expenses   | \$ 177,090   | \$ 149,670 |
| Equity in earnings of unconsolidated investees               | 1,881  | 661        |
| Earnings before income taxes                                 | \$ 31,142  | \$ 51,937  |
| Income tax expense   | 8,879  | 16,029     |
| Net earnings   | \$ 22,263  | \$ 35,908  |
| Other comprehensive earnings (loss), net of tax              | (6,931)  | (16,136)   |
| Comprehensive earnings                                       | \$ 15,332  | \$ 19,772  |
| Earnings per share:  |  |            |
| Basic:   |  |            |
| Basic net earnings per share                                 | \$ 0.51  | \$ 0.83    |
| Basic comprehensive earnings per share                       | \$ 0.35  | \$ 0.46    |
| Diluted:   |  |            |

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|  |         |         |
|--|---------|---------|
| Diluted net earnings per share                       | \$ 0.50 | \$ 0.81 |
| Diluted comprehensive earnings per share             | \$ 0.34 | \$ 0.45 |
| Weighted average number of common shares outstanding |         |         |
| Basic  | 43,843  | 43,342  |
| Diluted  | 44,492  | 44,153  |
| Cash dividends paid per common share                 | \$ 0.20 | \$ 0.19 |

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

| (in thousands, except per share data)                        | For the Nine-Month Periods<br>Ended September 30, |            |
|--|---|------------|
|  | 2016  | 2015       |
| Net premiums earned  | \$ 540,739  | \$ 520,790 |
| Net investment income  | 39,922  | 40,890     |
| Net realized gains   | 23,457  | 25,622     |
| Other-than-temporary impairment (OTTI) losses on investments | (95)  | -          |
| Consolidated revenue   | \$ 604,023  | \$ 587,302 |
| Losses and settlement expenses                               | 259,340   | 218,461    |
| Policy acquisition costs                                     | 184,525   | 178,965    |
| Insurance operating expenses                                 | 38,950  | 37,297     |
| Interest expense on debt                                     | 5,570   | 5,570      |
| General corporate expenses                                   | 7,385   | 6,950      |
| Total expenses   | \$ 495,770  | \$ 447,243 |
| Equity in earnings of unconsolidated investees               | 10,823  | 11,041     |
| Earnings before income taxes                                 | \$ 119,076  | \$ 151,100 |
| Income tax expense   | 36,343  | 47,409     |
| Net earnings   | \$ 82,733   | \$ 103,691 |
| Other comprehensive earnings (loss), net of tax              | 33,898  | (48,663)   |
| Comprehensive earnings                                       | \$ 116,631  | \$ 55,028  |
| Earnings per share:  |   |            |
| Basic:   |   |            |
| Basic net earnings per share                                 | \$ 1.89   | \$ 2.40    |
| Basic comprehensive earnings per share                       | \$ 2.67   | \$ 1.27    |
| Diluted:   |   |            |
| Diluted net earnings per share                               | \$ 1.86   | \$ 2.35    |
| Diluted comprehensive earnings per share                     | \$ 2.63   | \$ 1.25    |
| Weighted average number of common shares outstanding         |   |            |
| Basic  | 43,721  | 43,232     |
| Diluted  | 44,416  | 44,031     |
| Cash dividends paid per common share                         | \$ 0.59   | \$ 0.56    |



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

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## RLI Corp. and Subsidiaries

## Condensed Consolidated Balance Sheets

(Unaudited)

| (in thousands, except share data)  | September<br>30,<br>2016 | December<br>31,<br>2015 |
|--|--------------------------|-------------------------|
| <b>ASSETS</b>  |                          |                         |
| Investments  |                          |                         |
| Fixed income   |                          |                         |
| Available-for-sale, at fair value (amortized cost - \$1,624,868 at 9/30/16 and \$1,518,156 at 12/31/15)  | \$ 1,687,605             | \$ 1,538,110            |
| Equity securities available-for-sale, at fair value (cost - \$200,595 at 9/30/16 and \$202,437 at 12/31/15)  | 382,282                  | 375,424                 |
| Short-term investments, at cost which approximates fair value  | 8,392                    | 6,262                   |
| Other invested assets  | 24,502                   | 20,666                  |
| Cash   | 13,970                   | 11,081                  |
| Total investments and cash   | \$ 2,116,751             | \$ 1,951,543            |
| Accrued investment income  | 13,311                   | 14,878                  |
| Premiums and reinsurance balances receivable, net of allowances for uncollectible amounts of \$15,739 at 9/30/16 and \$14,898 at 12/31/15                              | 136,214                  | 143,662                 |
| Ceded unearned premium   | 54,014                   | 52,833                  |
| Reinsurance balances recoverable on unpaid losses and settlement expenses, net of allowances for uncollectible amounts of \$10,956 at 9/30/16 and \$11,885 at 12/31/15 | 292,943                  | 297,844                 |
| Deferred policy acquisition costs  | 75,805                   | 69,829                  |
| Property and equipment, at cost, net of accumulated depreciation of \$43,011 at 9/30/16 and \$38,447 at 12/31/15   | 53,643                   | 47,102                  |
| Investment in unconsolidated investees   | 82,276                   | 70,784                  |
| Goodwill and intangibles   | 64,578                   | 71,294                  |
| Other assets   | 23,999                   | 15,696                  |
| <b>TOTAL ASSETS</b>  | <b>\$ 2,913,534</b>      | <b>\$ 2,735,465</b>     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                          |                         |
| <b>Liabilities</b>   |                          |                         |
| Unpaid losses and settlement expenses  | \$ 1,150,938             | \$ 1,103,785            |
| Unearned premiums  | 449,051                  | 422,094                 |
| Reinsurance balances payable   | 17,425                   | 37,556                  |
| Funds held   | 77,902                   | 54,254                  |
| Income taxes-deferred  | 85,152                   | 63,993                  |
| Bonds payable, long-term debt  | 148,694                  | 148,554                 |
| Accrued expenses   | 40,029                   | 55,742                  |
| Other liabilities  | 21,929                   | 26,018                  |
| <b>TOTAL LIABILITIES</b>   | <b>\$ 1,991,120</b>      | <b>\$ 1,911,996</b>     |

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|   |                     |                     |
|---|---------------------|---------------------|
| Shareholders' Equity  |                     |                     |
| Common stock (\$1 par value, 100,000,000 shares authorized)           |                     |                     |
| (66,837,167 shares issued, 43,906,953 shares outstanding at 9/30/16)  |                     |                     |
| (66,474,342 shares issued, 43,544,128 shares outstanding at 12/31/15) | \$ 66,837           | \$ 66,474           |
| Paid-in capital   | 229,107             | 221,345             |
| Accumulated other comprehensive earnings                              | 157,672             | 123,774             |
| Retained earnings   | 861,797             | 804,875             |
| Deferred compensation   | 10,395              | 10,647              |
| Less: Treasury shares at cost   |                     |                     |
| (22,930,214 shares at 9/30/16 and 12/31/15)                           | (403,394)           | (403,646)           |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>                                     | <b>\$ 922,414</b>   | <b>\$ 823,469</b>   |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                     | <b>\$ 2,913,534</b> | <b>\$ 2,735,465</b> |

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

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

| (in thousands)                                    | For the Nine-Month Periods<br>Ended September 30, |              |
|---|---|--------------|
|   | 2016  | 2015         |
| Net cash provided by operating activities         | \$ 123,000  | \$ 121,367   |
| Cash Flows from Investing Activities              |   |              |
| Investments purchased                             | \$ (434,505)                                      | \$ (540,159) |
| Investments sold                                  | 243,506   | 349,411      |
| Investments called or matured                     | 102,752   | 135,750      |
| Net change in short-term investments              | (1,476)   | (43,745)     |
| Net property and equipment purchased              | (11,852)  | (6,405)      |
| Investment in equity method investee              | -   | (1,711)      |
| Acquisition of agency                             | (850)   | -            |
| Net cash used in investing activities             | \$ (102,425)                                      | \$ (106,859) |
| Cash Flows from Financing Activities              |   |              |
| Cash dividends paid                               | \$ (25,811)                                       | \$ (24,221)  |
| Stock plan share issuance                         | (357)   | 39           |
| Excess tax benefit from exercise of stock options | 8,482   | 7,242        |
| Net cash used in financing activities             | \$ (17,686)                                       | \$ (16,940)  |
| Net increase (decrease) in cash                   | \$ 2,889  | \$ (2,432)   |
| Cash at the beginning of the period               | \$ 11,081   | \$ 30,620    |
| Cash at September 30                              | \$ 13,970   | \$ 28,188    |

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. BASIS OF PRESENTATION

The unaudited condensed consolidated interim financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 2015 Annual Report on Form 10-K. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position at September 30, 2016 and the results of operations of RLI Corp. and subsidiaries for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the operating results for a full year.

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

B. ADOPTED ACCOUNTING STANDARDS

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

This ASU was issued to simplify the presentation of debt issuance costs by requiring them to be presented in the balance sheet as a direct deduction from the carrying amount of the related recognized debt liability, consistent with debt discounts. We adopted ASU 2015-03 on January 1, 2016 on a retrospective basis. Our adoption of the new standard resulted in a \$1.1 million decrease to long-term debt and other assets at December 31, 2015.

C. PROSPECTIVE ACCOUNTING STANDARDS

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

This ASU was issued to enhance disclosures about an entity's insurance liabilities, including the nature, amount, timing and uncertainty of cash flows related to those liabilities. The new guidance requires the following information related to unpaid claims and claim adjustment expenses be disclosed using an appropriate level of disaggregation so as not to obscure useful information:

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

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

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

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

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

This ASU is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is only permitted for provision (e) above. Upon adoption, a cumulative-effect adjustment to the balance sheet will be made as of the beginning of the fiscal year of adoption. We have not yet completed the analysis of how adopting this ASU will affect our financial statements.

ASU 2016-02, Leases (Topic 842)

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

This ASU is effective for annual and interim reporting periods beginning after December 15, 2018. Early adoption is permitted. Upon adoption, leases will be recognized and measured at the beginning of the earliest period presented

using a modified retrospective approach. We have not yet completed the analysis of how adopting this ASU will affect our financial statements.

ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

ASU 2016-09 was issued to simplify the accounting for share-based payment awards. The guidance requires that, prospectively, all tax effects related to share-based payments be made through the income statement at the time of settlement as opposed to excess tax benefits being recognized in additional paid-in-capital under the current guidance. The ASU also removes the requirement to delay recognition of a tax benefit until it reduces current taxes payable. This change is required to be applied on a modified retrospective basis, with a cumulative-effect adjustment to opening retained earnings. Additionally, all tax related cash flows resulting from share-based payments are to be reported as operating activities on the statement of cash flows, a change from the current requirement to present tax benefits as an inflow from financing activities and an outflow from operating activities. Finally, entities will be allowed to withhold an amount up to the employees' maximum individual tax rate (as opposed to the minimum statutory tax rate) in the relevant jurisdiction without resulting in liability classification of the award. The change in withholding requirements will be applied on a modified retrospective approach.

This ASU is effective for annual and interim reporting periods beginning after December 15, 2016. Early adoption is permitted with any adjustments reflected as of the beginning of the fiscal year of adoption. The primary impact this guidance



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will have on our financial statements relates to the provision concerning the recognition of tax effects through the income statement. The impact to our income statement will vary depending upon the level of intrinsic value associated with option exercises in a particular period.

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

ASU 2016-13 was issued to provide more decision-useful information about the expected credit losses on financial instruments. Current GAAP delays the recognition of credit losses until it is probable a loss has been incurred. The update will require a financial asset measured at amortized cost to be presented at the net amount expected to be collected by means of an allowance for credit losses that runs through net income. Credit losses relating to available-for-sale debt securities will also be recorded through an allowance for credit losses. However, the amendments would limit the amount of the allowance to the amount by which fair value is below amortized cost. The measurement of credit losses on available-for-sale securities is similar under current GAAP, but the update requires the use of the allowance account through which amounts can be reversed, rather than through an irreversible write-down.

This ASU is effective for annual and interim reporting periods beginning after December 15, 2019. Early adoption is permitted beginning after December 15, 2018. Upon adoption, the update will be applied using the modified-retrospective approach, by which a cumulative-effect adjustment will be made to retained earnings as of the beginning of the first reporting period presented. We have not yet completed the analysis of how adopting this ASU will affect our financial statements.

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

ASU 2016-15 was issued to reduce the diversity in practice of how certain cash receipts and payments, for which current guidance is silent, are classified in the statement of cash flows. The update addresses eight specific issues, including contingent consideration payments made after a business combination, distributions received from equity method investees and the classification of cash receipts and payments that have aspects of more than one class of cash flows. This ASU is effective for annual and interim reporting periods beginning after December 15, 2017. Early adoption is permitted. Upon adoption, the update will be applied using the retrospective transition method. We have not yet completed the analysis of how adopting this ASU will affect our financial statements, but do not expect a material impact on our statement of cash flows.

D. INTANGIBLE ASSETS

In accordance with GAAP guidelines, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill and intangible assets totaled \$64.6 million and \$71.3 million at September 30, 2016 and December 31, 2015, respectively, as detailed in the following table.

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| Goodwill and Intangible Assets  | September | December  |
|---|-----------|-----------|
| (in thousands)  | 30,       | 31,       |
| Reporting Unit  | 2016      | 2015      |
| Goodwill  |           |           |
| Energy surety   | \$ 25,706 | \$ 25,706 |
| Miscellaneous and contract surety   | 15,110    | 15,110    |
| P&C package business  | 5,246     | 5,246     |
| Medical professional liability *  | 5,208     | 12,434    |
| Total goodwill  | \$ 51,270 | \$ 58,496 |
| Intangibles   |           |           |
| State insurance licenses  | \$ 7,500  | \$ 7,500  |
| Definite-lived intangibles, net of accumulated amortization of \$5,339 at 9/30/16 and \$4,678 at 12/31/15 | 5,808     | 5,298     |
| Total intangibles   | \$ 13,308 | \$ 12,798 |
| Total goodwill and intangibles  | \$ 64,578 | \$ 71,294 |

\* The September 30, 2016 medical professional liability goodwill balance reflects a \$7.2 million non-cash impairment charge recorded in the second quarter of 2016.

All definite-lived intangible assets are amortized against future operating results based on their estimated useful lives. Amortization of intangible assets was \$0.2 million for the third quarter of 2016 and \$0.7 million for the nine-month period ended September 30, 2016, compared to \$0.2 million for the third quarter of 2015 and \$0.7 million for the nine-month period ended September 30, 2015. Definite-lived intangibles increased during 2016 as a result of the asset acquisition from an insurance agency. Separately identifiable assets of the agency totaled \$1.2 million and related primarily to acquired software, trade name and agency relationships.

Annual impairment testing was performed on our energy surety goodwill, miscellaneous and contract surety goodwill, P&C package business goodwill and state insurance license indefinite-lived intangible asset during the second quarter of 2016. Based upon these reviews, none of the assets were impaired. In addition, as of September 30, 2016, there were no triggering events that occurred on the above mentioned goodwill and intangible assets that would suggest an updated review was necessary.

As disclosed in previous SEC filings, premium declines have decreased the fair value of our medical professional liability business in recent periods. Continuing rate and volume declines coupled with recent adverse loss experience resulted in a triggering event during the second quarter of 2016. A fair value was determined by using a weighted average of a market approach valuation and income approach (or discounted cash flow method) valuation. It was determined that the carrying cost of our medical professional liability goodwill exceeded the fair value. As a result, we recorded a \$7.2 million non-cash impairment charge included as a net realized loss in the consolidated statement of

earnings for the nine-month period ending September 30, 2016. There have been no additional triggering events subsequent to the second quarter 2016 impairment. As an additional consequence of the premium declines and adverse loss experience, the remaining portion of the contingent earn-out agreement associated with our acquisition of this medical professional liability business was eliminated, resulting in a \$1.5 million reduction to expenses for the nine-month period ending September 30, 2016.

#### E. EARNINGS PER SHARE

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

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

| (in thousands, except<br>per share data)   | For the Three-Month Period<br>Ended September 30, 2016 |                         |                     | For the Three-Month Period<br>Ended September 30, 2015 |                         |                     |
|--|--|-------------------------|---------------------|--|-------------------------|---------------------|
|  | Income<br>(Numerator)                                  | Shares<br>(Denominator) | Per Share<br>Amount | Income<br>(Numerator)                                  | Shares<br>(Denominator) | Per Share<br>Amount |
| <b>Basic EPS</b>                           |  |                         |                     |  |                         |                     |
| Income available to<br>common shareholders | \$ 22,263  | 43,843                  | \$ 0.51             | \$ 35,908  | 43,342                  | \$ 0.83             |
| Effect of Dilutive<br>Securities           |  |                         |                     |  |                         |                     |
| Stock options                              | -  | 649                     |                     | -  | 811                     |                     |
| <b>Diluted EPS</b>                         |  |                         |                     |  |                         |                     |
| Income available to<br>common shareholders | \$ 22,263  | 44,492                  | \$ 0.50             | \$ 35,908  | 44,153                  | \$ 0.81             |
| <b>For the Nine-Month Period</b>           |  |                         |                     |  |                         |                     |
| (in thousands, except<br>per share data)   | Ended September 30, 2016                               |                         |                     | Ended September 30, 2015                               |                         |                     |
|  | Income<br>(Numerator)                                  | Shares<br>(Denominator) | Per Share<br>Amount | Income<br>(Numerator)                                  | Shares<br>(Denominator) | Per Share<br>Amount |
| <b>Basic EPS</b>                           |  |                         |                     |  |                         |                     |
| Income available to<br>common shareholders | \$ 82,733  | 43,721                  | \$ 1.89             | \$ 103,691   | 43,232                  | \$ 2.40             |
| Effect of Dilutive<br>Securities           |  |                         |                     |  |                         |                     |
| Stock options                              | -  | 695                     |                     | -  | 799                     |                     |
| <b>Diluted EPS</b>                         |  |                         |                     |  |                         |                     |
| Income available to<br>common shareholders | \$ 82,733  | 44,416                  | \$ 1.86             | \$ 103,691   | 44,031                  | \$ 2.35             |

**F. COMPREHENSIVE EARNINGS**

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

Unrealized gains, net of tax, for the first nine months of 2016 were \$33.9 million, compared to unrealized losses, net of tax, of \$48.7 million during the same period last year. Unrealized gains in the first nine months of 2016 were primarily due to a decline in interest rates, increasing the value of the fixed income portfolio, and were aided by positive pricing movements for equity securities. In 2015, unrealized losses were the result of rising interest rates and an underperforming equity market.

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

| (in thousands)   | For the Three-Month Periods<br>Ended September 30, |             | For the Nine-Month Periods<br>Ended September 30, |             |
|--|--|-------------|---|-------------|
|  | 2016   | 2015        | 2016  | 2015        |
| Unrealized Gains/Losses on Available-for-Sale Securities           |  |             |   |             |
| Beginning balance  | \$ 164,603   | \$ 138,856  | \$ 123,774  | \$ 171,383  |
| Other comprehensive earnings before reclassifications              | (572)  | (11,257)    | 54,159  | (32,020)    |
| Amounts reclassified from accumulated other comprehensive earnings | (6,359)  | (4,879)     | (20,261)  | (16,643)    |
| Net current-period other comprehensive earnings (loss)             | \$ (6,931)   | \$ (16,136) | \$ 33,898   | \$ (48,663) |
| Ending balance   | \$ 157,672   | \$ 122,720  | \$ 157,672  | \$ 122,720  |

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

| (in thousands)   | Amount Reclassified from Accumulated Other Comprehensive Earnings |          |  |           | Affected line item in the Statement of Earnings              |
|--|---|----------|--|-----------|--|
|  | For the Three-Month Periods Ended September 30,                   |          | For the Nine-Month Periods Ended September 30, |           |  |
| Component of Accumulated Other Comprehensive Earnings        | 2016  | 2015     | 2016   | 2015      |  |
| Unrealized gains and losses on available-for-sale securities | \$ 9,878  | \$ 7,507 | \$ 31,266                                      | \$ 25,604 | Net realized gains   |
|  | (95)  | -        | (95)   | -         | Other-than-temporary impairment (OTTI) losses on investments |
|  | \$ 9,783  | \$ 7,507 | \$ 31,171                                      | \$ 25,604 | Earnings before income taxes                                 |
|  | (3,424)   | (2,628)  | (10,910)                                       | (8,961)   | Income tax expense   |
|  | \$ 6,359  | \$ 4,879 | \$ 20,261                                      | \$ 16,643 | Net earnings   |

## 2. INVESTMENTS

Our investments are primarily composed of fixed income debt securities and common stock equity securities. As disclosed in our 2015 Annual Report on Form 10-K, we present all of our investments as available-for-sale, which are carried at fair value. When available, we obtain quoted market prices to determine fair value for our investments. If a quoted market price is not available, fair value is estimated using a secondary pricing source or using quoted market prices of similar securities. We have no investment securities for which fair value is determined using Level 3 inputs as defined in note 3 to the unaudited condensed consolidated interim financial statements, "Fair Value Measurements."

### Available-for-Sale Securities

The amortized cost and fair value of available-for-sale securities at September 30, 2016 and December 31, 2015 were as follows:

Available-for-sale  
(in thousands)

| Asset Class             | September 30, 2016           |                              |                               |               |
|-------------------------|------------------------------|------------------------------|-------------------------------|---------------|
|                         | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. government         | \$ 82,796                    | \$ 1,523                     | \$ (6)                        | \$ 84,313     |
| U.S. agency             | 11,493                       | 807                          | -                             | 12,300        |
| Non-U.S. govt. & agency | 6,037                        | 153                          | (190)                         | 6,000         |
| Agency MBS              | 302,761                      | 9,603                        | (279)                         | 312,085       |
| ABS/CMBS*               | 116,156                      | 2,322                        | (242)                         | 118,236       |
| Corporate               | 563,045                      | 22,093                       | (4,464)                       | 580,674       |
| Municipal               | 542,580                      | 31,647                       | (230)                         | 573,997       |
| Total Fixed Income      | \$ 1,624,868                 | \$ 68,148                    | \$ (5,411)                    | \$ 1,687,605  |
| Equity                  | \$ 200,595                   | \$ 182,616                   | \$ (929)                      | \$ 382,282    |



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(in thousands)

| Asset Class             | December 31, 2015            |                              |                               |               |
|-------------------------|------------------------------|------------------------------|-------------------------------|---------------|
|                         | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| U.S. government         | \$ 43,597                    | \$ 58                        | \$ (112)                      | \$ 43,543     |
| U.S. agency             | 15,481                       | 306                          | (47)                          | 15,740        |
| Non-U.S. govt. & agency | 5,035                        | -                            | (557)                         | 4,478         |
| Agency MBS              | 250,060                      | 6,451                        | (1,619)                       | 254,892       |
| ABS/CMBS*               | 91,559                       | 995                          | (606)                         | 91,948        |
| Corporate               | 523,351                      | 8,565                        | (14,807)                      | 517,109       |
| Municipal               | 589,073                      | 21,375                       | (48)                          | 610,400       |
| Total Fixed Income      | \$ 1,518,156                 | \$ 37,750                    | \$ (17,796)                   | \$ 1,538,110  |
| Equity                  | \$ 202,437                   | \$ 174,443                   | \$ (1,456)                    | \$ 375,424    |

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

The following table presents the amortized cost and fair value of available-for-sale debt securities by contractual maturity dates as of September 30, 2016:

| Available-for-sale<br>(in thousands)  | September 30, 2016 |               |
|---------------------------------------|--------------------|---------------|
|                                       | Amortized<br>Cost  | Fair<br>Value |
| Due in one year or less               | \$ 29,101          | \$ 29,173     |
| Due after one year through five years | 357,543            | 365,930       |
| Due after five years through 10 years | 544,117            | 571,544       |
| Due after 10 years                    | 275,190            | 290,637       |
| Mtge/ABS/CMBS*                        | 418,917            | 430,321       |
| Total available-for-sale              | \$ 1,624,868       | \$ 1,687,605  |

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

## Unrealized Losses

We conduct and document periodic reviews of all securities with unrealized losses to evaluate whether the impairment

is other-than-temporary. The following tables are used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of September 30, 2016 and December 31, 2015. The tables segregate the securities based on type, noting the fair value, cost (or amortized cost) and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position. As of September 30, 2016 unrealized losses, as shown in the following tables, were 0.3 percent of total invested assets. Unrealized losses decreased in 2016, due largely to interest rates declines from the end of 2015, which increased the fair value of securities held in the fixed income portfolio.

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| (in thousands)                | September 30, 2016 |                      |            | December 31, 2015 |                      |             |
|-------------------------------|--------------------|----------------------|------------|-------------------|----------------------|-------------|
|                               | < 12 Mos.          | 12 Mos. &<br>Greater | Total      | < 12 Mos.         | 12 Mos. &<br>Greater | Total       |
| <b>U.S. Government</b>        |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 2,021           | \$ —                 | \$ 2,021   | \$ 36,000         | \$ —                 | \$ 36,000   |
| Cost or amortized cost        | 2,027              | —                    | 2,027      | 36,112            | —                    | 36,112      |
| Unrealized Loss               | \$ (6)             | \$ —                 | \$ (6)     | \$ (112)          | \$ —                 | \$ (112)    |
| <b>U.S. Agency</b>            |                    |                      |            |                   |                      |             |
| Fair value                    | \$ —               | \$ —                 | \$ —       | \$ 8,070          | \$ —                 | \$ 8,070    |
| Cost or amortized cost        | —                  | —                    | —          | 8,117             | —                    | 8,117       |
| Unrealized Loss               | \$ —               | \$ —                 | \$ —       | \$ (47)           | \$ —                 | \$ (47)     |
| <b>Non-U.S. government</b>    |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 3,849           | \$ —                 | \$ 3,849   | \$ 4,478          | \$ —                 | \$ 4,478    |
| Cost or amortized cost        | 4,039              | —                    | 4,039      | 5,035             | —                    | 5,035       |
| Unrealized Loss               | \$ (190)           | \$ —                 | \$ (190)   | \$ (557)          | \$ —                 | \$ (557)    |
| <b>Agency MBS</b>             |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 42,710          | \$ 9,028             | \$ 51,738  | \$ 100,424        | \$ 18,520            | \$ 118,944  |
| Cost or amortized cost        | 42,789             | 9,228                | 52,017     | 101,473           | 19,090               | 120,563     |
| Unrealized Loss               | \$ (79)            | \$ (200)             | \$ (279)   | \$ (1,049)        | \$ (570)             | \$ (1,619)  |
| <b>ABS/CMBS*</b>              |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 31,680          | \$ 6,540             | \$ 38,220  | \$ 51,091         | \$ 8,364             | \$ 59,455   |
| Cost or amortized cost        | 31,848             | 6,614                | 38,462     | 51,562            | 8,499                | 60,061      |
| Unrealized Loss               | \$ (168)           | \$ (74)              | \$ (242)   | \$ (471)          | \$ (135)             | \$ (606)    |
| <b>Corporate</b>              |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 23,768          | \$ 24,065            | \$ 47,833  | \$ 275,404        | \$ 15,174            | \$ 290,578  |
| Cost or amortized cost        | 23,927             | 28,370               | 52,297     | 285,515           | 19,870               | 305,385     |
| Unrealized Loss               | \$ (159)           | \$ (4,305)           | \$ (4,464) | \$ (10,111)       | \$ (4,696)           | \$ (14,807) |
| <b>Municipal</b>              |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 30,266          | \$ —                 | \$ 30,266  | \$ 8,462          | \$ 2,418             | \$ 10,880   |
| Cost or amortized cost        | 30,496             | —                    | 30,496     | 8,504             | 2,424                | 10,928      |
| Unrealized Loss               | \$ (230)           | \$ —                 | \$ (230)   | \$ (42)           | \$ (6)               | \$ (48)     |
| <b>Subtotal, fixed income</b> |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 134,294         | \$ 39,633            | \$ 173,927 | \$ 483,929        | \$ 44,476            | \$ 528,405  |
| Cost or amortized cost        | 135,126            | 44,212               | 179,338    | 496,318           | 49,883               | 546,201     |
| Unrealized Loss               | \$ (832)           | \$ (4,579)           | \$ (5,411) | \$ (12,389)       | \$ (5,407)           | \$ (17,796) |
| <b>Equity securities</b>      |                    |                      |            |                   |                      |             |
| Fair value                    | \$ 4,071           | \$ 2,225             | \$ 6,296   | \$ 16,476         | \$ —                 | \$ 16,476   |

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|                        |            |            |            |             |            |             |
|------------------------|------------|------------|------------|-------------|------------|-------------|
| Cost or amortized cost | 4,577      | 2,648      | 7,225      | 17,932      | —          | 17,932      |
| Unrealized Loss        | \$ (506)   | \$ (423)   | \$ (929)   | \$ (1,456)  | \$ —       | \$ (1,456)  |
| <b>Total</b>           |            |            |            |             |            |             |
| Fair value             | \$ 138,365 | \$ 41,858  | \$ 180,223 | \$ 500,405  | \$ 44,476  | \$ 544,881  |
| Cost or amortized cost | 139,703    | 46,860     | 186,563    | 514,250     | 49,883     | 564,133     |
| Unrealized Loss        | \$ (1,338) | \$ (5,002) | \$ (6,340) | \$ (13,845) | \$ (5,407) | \$ (19,252) |

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

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The following table shows the composition of the fixed income securities in unrealized loss positions at September 30, 2016 by the National Association of Insurance Commissioners (NAIC) rating and the generally equivalent Standard & Poor's (S&P) and Moody's ratings. The vast majority of the securities are rated by S&P and/or Moody's.

| NAIC Rating | Equivalent S&P Rating | Equivalent Moody's Rating | (dollars in thousands) |            | Unrealized Loss | Percent to Total |   |
|-------------|-----------------------|---------------------------|------------------------|------------|-----------------|------------------|---|
|             |                       |                           | Amortized Cost         | Fair Value |                 |                  |   |
| 1           | AAA/AA/A              | Aaa/Aa/A                  | \$ 143,545             | \$ 142,648 | \$ (897)        | 16.6             | % |
| 2           | BBB                   | Baa                       | 11,779                 | 11,499     | (280)           | 5.2              | % |
| 3           | BB                    | Ba                        | 1,796                  | 1,719      | (77)            | 1.4              | % |
| 4           | B                     | B                         | 17,186                 | 14,594     | (2,592)         | 47.9             | % |
| 5           | CCC or lower          | Caa or lower              | 5,032                  | 3,467      | (1,565)         | 28.9             | % |
| 6           |                       |                           | —                      | —          | —               | —                |   |
|             |                       | Total                     | \$ 179,338             | \$ 173,927 | \$ (5,411)      | 100.0            | % |

## Evaluating Investments for OTTI

The fixed income portfolio contained 130 securities in an unrealized loss position as of September 30, 2016. The \$5.4 million in associated unrealized losses for these 130 securities represents 0.3 percent of the fixed income portfolio's cost basis. Of these 130 securities, 58 have been in an unrealized loss position for 12 consecutive months or longer. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. Any credit-related impairment related to fixed income securities we do not plan to sell and for which we are not more likely than not to be required to sell is recognized in net earnings, with the non-credit related impairment recognized in comprehensive earnings. Based on our analysis, our fixed income portfolio is of high credit quality and we believe we will recover the amortized cost basis of our fixed income securities. We continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. In the third quarter of 2016, we recognized \$0.1 million in other-than-temporary impairment (OTTI) charges in earnings on a fixed income security that we no longer had the intent to hold. Comparatively, we did not recognize any OTTI losses in earnings on the fixed income portfolio in 2015. There were no OTTI losses recognized in other comprehensive earnings on the fixed income portfolio for the periods presented.

As of September 30, 2016, we held three common stock securities that were in an unrealized loss position. The unrealized loss on these securities was \$0.9 million. Based on our analysis, we believe each security will recover in a reasonable period of time and we have the intent and ability to hold them until recovery. One equity security has been in an unrealized loss position for 12 consecutive months or longer. There were no OTTI losses recognized in the periods presented on the equity portfolio.

#### Other Invested Assets

Other invested assets include investments in three low income housing tax credit partnerships (LIHTC), carried at amortized cost, membership in the Federal Home Loan Bank of Chicago (FHLBC), carried at cost, and an investment in a real estate fund, carried at cost. Due to the nature of the LIHTC and our membership in the FHLBC, their carrying amounts approximate fair value. Our LIHTC interests had a balance of \$17.9 million at September 30, 2016, compared to \$14.0 million at December 31, 2015 and recognized a total tax benefit of \$0.4 million during the third quarter of 2016 compared to \$0.3 million during the third quarter of 2015. For the nine-month periods ended September 30, 2016 and 2015, our LIHTC interests recognized a total tax benefit of \$1.2 and \$0.8, respectively. Our investment in FHLBC stock totaled \$1.6 million at September 30, 2016 and December 31, 2015. Our investment in the real estate fund was carried at \$5.0 million and had a fair value of \$5.1 million at September 30, 2016, compared to a carrying value of \$5.0 million, which approximated fair value, at December 31, 2015.

#### Cash and Short-term Investments

Cash consists of uninvested balances in bank accounts. We had a cash balance of \$14.0 million at the end of the third quarter of 2016, compared to \$11.1 million at the end of 2015. Short-term investments of \$8.4 million and \$6.3 million at September 30, 2016 and December 31, 2015, respectively, are carried at cost, which approximates fair value.

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3. FAIR VALUE MEASUREMENTS

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

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

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

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

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

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

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

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

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

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

Common Stock: Exchange traded equities have readily observable price levels and are classified as Level 1 (fair value based on quoted market prices). All of our common stock holdings are deemed Level 1.

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



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

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

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

| (in thousands)                      | As of September 30, 2016   |   |   | Total        |
|-------------------------------------|--|---|---|--------------|
|                                     | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |              |
| Available-for-sale securities       |  |   |   |              |
| U.S. government                     | \$ —   | \$ 84,313                               | \$ —                                      | \$ 84,313    |
| U.S. agency                         | —  | 12,300                                  | —   | 12,300       |
| Non-U.S. govt. & agency             | —  | 6,000                                   | —   | 6,000        |
| Agency MBS                          | —  | 312,085                                 | —   | 312,085      |
| ABS/CMBS*                           | —  | 118,236                                 | —   | 118,236      |
| Corporate                           | —  | 580,674                                 | —   | 580,674      |
| Municipal                           | —  | 573,997                                 | —   | 573,997      |
| Equity                              | 382,282  | —                                       | —   | 382,282      |
| Total available-for-sale securities | \$ 382,282   | \$ 1,687,605                            | \$ —                                      | \$ 2,069,887 |

  

| (in thousands)                | As of December 31, 2015  |   |   | Total     |
|-------------------------------|--|---|---|-----------|
|                               | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |           |
| Available-for-sale securities |  |   |   |           |
| U.S. government               | \$ —   | \$ 43,543                               | \$ —                                      | \$ 43,543 |
| U.S. agency                   | —  | 15,740                                  | —   | 15,740    |
| Non-U.S. govt. & agency       | —  | 4,478                                   | —   | 4,478     |
| Agency MBS                    | —  | 254,892                                 | —   | 254,892   |

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|                                     |            |              |      |              |
|-------------------------------------|------------|--------------|------|--------------|
| ABS/CMBS*                           | —          | 91,948       | —    | 91,948       |
| Corporate                           | —          | 517,109      | —    | 517,109      |
| Municipal                           | —          | 610,400      | —    | 610,400      |
| Equity                              | 375,424    | —            | —    | 375,424      |
| Total available-for-sale securities | \$ 375,424 | \$ 1,538,110 | \$ — | \$ 1,913,534 |

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

As noted in the above table, we did not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period. Additionally, there were no securities transferred in or out of levels 1 or 2 during the nine-month period ended September 30, 2016.

#### 4. INCOME TAXES

Our effective tax rate for the three and nine-month periods ended September 30, 2016 was 28.5 percent and 30.5 percent, respectively, compared to 30.9 percent and 31.4 percent, respectively, for the same periods in 2015. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate was slightly lower for the three and nine-month periods ended September 30, 2016. While the dollar amount of tax favored adjustments were similar year over year, they were slightly larger on a percentage basis due to lower levels of pre-tax earnings.

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Income tax expense attributable to income from operations for the three and nine-month periods ended September 30, 2016 and 2015 differed from the amounts computed by applying the U.S. federal tax rate of 35 percent to pretax income as a result of the following:

| (in thousands)  | For the Three-Month Periods Ended September 30, |         |           |         | For the Nine-Month Periods Ended September 30, |         |           |         |
|---|---|---------|-----------|---------|--|---------|-----------|---------|
|   | 2016  |         | 2015      |         | 2016   |         | 2015      |         |
|   | Amount  | %       | Amount    | %       | Amount   | %       | Amount    | %       |
| Provision for income taxes at the statutory rate of 35% | \$ 10,900                                       | 35.0 %  | \$ 18,178 | 35.0 %  | \$ 41,677                                      | 35.0 %  | \$ 52,885 | 35.0 %  |
| Increase (reduction) in taxes resulting from:           |   |         |           |         |  |         |           |         |
| Tax exempt interest income                              | (1,020)   | (3.2) % | (1,082)   | (2.1) % | (3,149)  | (2.6) % | (3,098)   | (2.0) % |
| Dividends received deduction                            | (626)   | (2.0) % | (603)     | (1.2) % | (1,676)  | (1.4) % | (1,715)   | (1.1) % |
| ESOP dividends paid deduction                           | (238)   | (0.8) % | (234)     | (0.4) % | (714)  | (0.6) % | (693)     | (0.5) % |
| Other items, net  | (137)   | (0.5) % | (230)     | (0.4) % | 205  | 0.1 %   | 30        | 0.0 %   |
| Total tax expense                                       | \$ 8,879  | 28.5 %  | \$ 16,029 | 30.9 %  | \$ 36,343                                      | 30.5 %  | \$ 47,409 | 31.4 %  |

## 5. STOCK BASED COMPENSATION

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

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

options under the 2010 LTIP. The 2010 LTIP was replaced in 2015.

In 2015, our shareholders approved the 2015 RLI Corp. Long-Term Incentive Plan (2015 LTIP), which provides for equity-based compensation and replaced the 2010 LTIP. In conjunction with the adoption of the 2015 LTIP, effective May 7, 2015, options were no longer granted under the 2010 LTIP. Awards under the 2015 LTIP may be in the form of restricted stock, stock options (non-qualified only), stock appreciation rights, performance units as well as other stock-based awards. Eligibility under the 2015 LTIP is limited to employees and directors of the company or any affiliate. The granting of awards under the 2015 LTIP is solely at the discretion of the board of directors. The maximum number of shares of common stock available for distribution under the 2015 LTIP is 4,000,000 shares (subject to adjustment for changes in our capitalization and other events). Since 2015, we have granted 920,250 stock options under the 2015 LTIP, including 410,250 thus far in 2016.

Under the 2015 LTIP, as under the 2010 LTIP and omnibus plan, we grant stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant (subject to adjustments for changes in our capitalization, special dividends and other events as set forth in such plans). Options generally vest and become exercisable ratably over a five-year period and expire eight years after grant.

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

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The following tables summarize option activity for the periods ended September 30, 2016 and 2015:

|   | 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, 2016    | 2,582,220                           | \$ 32.42                                 |   |   |
| Options granted                           | 410,250                             | \$ 64.15                                 |   |   |
| Options exercised                         | (638,675)                           | \$ 23.67                                 |   | \$ 27,704                                     |
| Options canceled/forfeited                | (8,940)                             | \$ 41.90                                 |   |   |
| Outstanding options at September 30, 2016 | 2,344,855                           | \$ 40.32                                 | 5.12  | \$ 65,748                                     |
| Exercisable options at September 30, 2016 | 939,785                             | \$ 31.10                                 | 3.58  | \$ 35,016                                     |

|   | Number of<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in 000's) |
|---|-------------------------------------|--|---|---|
| Outstanding options at January 1, 2015    | 2,892,717                           | \$ 26.65                                 |   |   |
| Options granted                           | 517,000                             | \$ 50.09                                 |   |   |
| Options exercised                         | (511,187)                           | \$ 18.27                                 |   | \$ 17,845                                     |
| Options canceled/forfeited                | (4,560)                             | \$ 31.87                                 |   |   |
| Outstanding options at September 30, 2015 | 2,893,970                           | \$ 32.31                                 | 5.29  | \$ 61,522                                     |
| Exercisable options at September 30, 2015 | 1,197,470                           | \$ 23.89                                 | 4.01  | \$ 35,497                                     |

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

Thus far in 2016, 410,250 stock options were granted with a weighted average exercise price of \$64.15 and a weighted average fair value of \$11.47. We recognized \$1.0 million of expense in the third quarter of 2016 and \$3.2 million in the first nine months of 2016 related to options vesting. Since options granted under our 2010 LTIP and 2015 LTIP are non-qualified, we recorded a tax benefit of \$0.4 million in the third quarter of 2016 and \$1.1 million in the first nine months of 2016 related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$7.1 million, which will be recognized over the remainder of the vesting period. Comparatively, we recognized \$1.1 million of expense in the third quarter of 2015 and \$3.0 million of expense in the first nine months of 2015. We recorded a tax benefit of \$0.4 million in the third quarter of 2015 and \$1.1 million in the first nine months of 2015 related to this compensation expense.

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

|                                       | 2016       | 2015       |
|---------------------------------------|------------|------------|
| Weighted-average fair value of grants | \$ 11.47   | \$ 9.04    |
| Risk-free interest rates              | 1.21 %     | 1.53 %     |
| Dividend yield                        | 1.61 %     | 1.81 %     |
| Expected volatility                   | 23.06 %    | 22.89 %    |
| Expected option life                  | 5.04 years | 5.21 years |

The risk-free rate was determined based on U.S. treasury yields that most closely approximated the option's expected life. The dividend yield was calculated based on the average annualized ordinary dividends paid during the most recent five-year period. It excluded the special dividends paid in the fourth quarters of 2015 and prior years. The expected volatility was calculated based on the median of the rolling volatilities for the expected life of the options. The expected option life was determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant.

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## 6. OPERATING SEGMENT INFORMATION

Selected information by operating segment is presented in the table below. Additionally, the table reconciles segment totals to total earnings and total revenues.

| REVENUES<br>(in thousands)                     | For the Three-Month Periods<br>Ended September 30, |            | For the Nine-Month Periods<br>Ended September 30, |            |
|--|--|------------|---|------------|
|  | 2016   | 2015       | 2016  | 2015       |
| Casualty                                       | \$ 115,619   | \$ 105,160 | \$ 336,572  | \$ 305,842 |
| Property                                       | 37,532   | 44,685     | 114,011   | 128,084    |
| Surety   | 30,444   | 29,603     | 90,156  | 86,864     |
| Net premiums earned                            | \$ 183,595   | \$ 179,448 | \$ 540,739  | \$ 520,790 |
| Net investment income                          | 13,504   | 13,964     | 39,922  | 40,890     |
| Net realized gains                             | 9,252  | 7,534      | 23,362  | 25,622     |
| Total consolidated revenue                     | \$ 206,351   | \$ 200,946 | \$ 604,023  | \$ 587,302 |
| <br>NET EARNINGS<br>(in thousands)             | <br>2016   | <br>2015   | <br>2016  | <br>2015   |
| Casualty                                       | \$ 259   | \$ 13,651  | \$ 20,490   | \$ 38,124  |
| Property                                       | 468  | 9,216      | 13,911  | 22,220     |
| Surety   | 9,877  | 10,726     | 23,523  | 25,723     |
| Net underwriting income                        | \$ 10,604  | \$ 33,593  | \$ 57,924   | \$ 86,067  |
| Net investment income                          | 13,504   | 13,964     | 39,922  | 40,890     |
| Net realized gains                             | 9,252  | 7,534      | 23,362  | 25,622     |
| General corporate expense and interest on debt | (4,099)  | (3,815)    | (12,955)  | (12,520)   |
| Equity in earnings of unconsolidated investees | 1,881  | 661        | 10,823  | 11,041     |
| Total earnings before income taxes             | \$ 31,142  | \$ 51,937  | \$ 119,076  | \$ 151,100 |
| Income tax expense                             | 8,879  | 16,029     | 36,343  | 47,409     |
| Total net earnings                             | \$ 22,263  | \$ 35,908  | \$ 82,733   | \$ 103,691 |

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

| NET PREMIUMS EARNED<br>(in thousands) | For the Three-Month Periods<br>Ended September 30, |                   | For the Nine-Month Periods<br>Ended September 30, |                   |
|---------------------------------------|--|-------------------|---|-------------------|
|                                       | 2016   | 2015              | 2016  | 2015              |
| <b>Casualty</b>                       |  |                   |   |                   |
| Commercial and personal umbrella      | \$ 27,844  | \$ 26,500         | \$ 82,510   | \$ 77,809         |
| General liability                     | 20,821   | 20,146            | 61,573  | 60,725            |
| Commercial transportation             | 21,557   | 17,464            | 60,037  | 47,262            |
| Professional services                 | 19,318   | 18,140            | 56,748  | 52,861            |
| P&C package business                  | 11,706   | 10,257            | 33,973  | 29,815            |
| Executive products                    | 4,716  | 4,459             | 14,126  | 13,745            |
| Medical professional liability        | 4,512  | 3,032             | 12,509  | 9,168             |
| Other casualty                        | 5,145  | 5,162             | 15,096  | 14,457            |
| Total                                 | \$ 115,619   | \$ 105,160        | \$ 336,572  | \$ 305,842        |
| <b>Property</b>                       |  |                   |   |                   |
| Commercial property                   | \$ 16,819  | \$ 18,546         | \$ 51,528   | \$ 57,498         |
| Marine                                | 11,964   | 12,029            | 36,070  | 34,930            |
| Specialty personal                    | 6,186  | 6,535             | 18,731  | 19,982            |
| Property reinsurance                  | 2,544  | 3,029             | 7,925   | 9,388             |
| Crop reinsurance                      | 19   | 4,523             | (243)   | 6,210             |
| Other property                        | -  | 23                | -   | 76                |
| Total                                 | \$ 37,532  | \$ 44,685         | \$ 114,011  | \$ 128,084        |
| <b>Surety</b>                         |  |                   |   |                   |
| Miscellaneous                         | \$ 11,714  | \$ 10,659         | \$ 34,304   | \$ 31,316         |
| Commercial                            | 7,221  | 7,546             | 22,030  | 22,039            |
| Contract                              | 6,906  | 7,472             | 20,332  | 21,091            |
| Energy                                | 4,603  | 3,926             | 13,490  | 12,418            |
| Total                                 | \$ 30,444  | \$ 29,603         | \$ 90,156   | \$ 86,864         |
| <b>Grand Total</b>                    | <b>\$ 183,595</b>                                  | <b>\$ 179,448</b> | <b>\$ 540,739</b>                                 | <b>\$ 520,790</b> |

## 7. ACQUISITION

On February 29, 2016, we acquired the assets of Associations Liability Insurance Agency, Inc. for \$1.2 million, which includes \$0.9 million of cash paid at acquisition and \$0.3 million associated with the present value of a contingent earn-out agreement. The earn-out is subject to the achievement of certain targets and may be adjusted in future periods



based on actual performance achieved. Separately identifiable assets of the agency totaling \$1.2 million and relating to acquired software, trade name and agency relationships were recognized.

On March 4, 2015 we invested an additional \$1.7 million in Prime Holdings Insurance Services, Inc. (Prime), increasing our total equity ownership to 27 percent. Prime writes business through two Illinois domiciled insurance carriers, Prime Insurance Company, an excess and surplus lines company, and Prime Property and Casualty Insurance Inc., an admitted insurance company. The investment in Prime is reflected on our balance sheet as an investment in unconsolidated investee. Under the equity method of accounting we recognize our proportionate share of Prime's income as equity in earnings of unconsolidated investees. Our share of Prime's earnings amounted to \$0.3 million in the third quarter of 2016 and \$0.9 million in the first nine months of 2016. Comparatively, our share of Prime's earnings amounted to \$0.2 million in the third quarter of 2015 and \$0.9 million in the first nine months of 2015.

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

“SAFE HARBOR” STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: This discussion and analysis may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Various risk factors that could affect future results are listed in our filings with the Securities and Exchange Commission, including the Annual Report on Form 10-K for the year ended December 31, 2015.

OVERVIEW

RLI Corp. is an Illinois corporation that was organized in 1965. We underwrite selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group (the Group). We conduct operations principally through three insurance companies. RLI Insurance Company (RLI Ins.), a subsidiary of RLI Corp. and our principal insurance subsidiary, writes multiple lines of insurance on an admitted basis in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. Mt. Hawley Insurance Company (Mt. Hawley), a subsidiary of RLI Ins., writes excess and surplus lines insurance on a non-admitted basis in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. Contractors Bonding and Insurance Company (CBIC), a subsidiary of RLI Ins., writes multiple lines of insurance on an admitted basis in all 50 states and the District of Columbia. Each of our insurance companies is domiciled in Illinois.

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

underwriters determine whether it would be a viable product based on our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all market conditions and we have achieved this for 20 consecutive years, averaging an 87.3 combined ratio over that period of time. This foundation drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly-rated, diversified, liquid, investment-grade securities. Consistent underwriting income allows a portion of our shareholders' equity to be invested in equity securities. Our equity portfolio consists of a core stock portfolio weighted toward dividend-paying stocks, as well as exchange traded funds (ETFs). Our minority equity ownership interests in Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality sunglasses, and Prime Holdings Insurance Services, Inc. (Prime), a specialty excess and surplus insurance company, has also enhanced overall returns. We have a diversified investment portfolio and closely monitor our investment risks. Despite periodic fluctuations in market value, our equity portfolio is part of a long-term asset allocation strategy and has contributed significantly to our historical 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.

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

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

The casualty portion of our business consists largely of general liability, personal umbrella, transportation, executive products and commercial umbrella coverages, as well as package business and other specialty coverages, such as professional liability and workers compensation for office-based professionals. We offer fidelity and crime coverage for commercial insureds and select financial institutions and 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 treaty reinsurance. We also offer select personal lines policies, such as recreational vehicle, jewelry and Hawaii homeowners coverages. While our marine coverages are predominantly domestic risks, this portfolio does contain a relatively small portion of foreign risks. Property insurance and reinsurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our second largest catastrophe exposure is to losses caused by wind storms to commercial properties throughout the Gulf and East Coast, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by minimizing the total policy limits written in a particular region, purchasing reinsurance and maintaining policy terms and conditions throughout market cycles. We also use computer-assisted modeling techniques to provide estimates that help us carefully manage the concentration of risks exposed to catastrophic events. As noted in previous filings, our assumed crop reinsurance business was reduced for 2015 and expired at the end of the 2015 crop year due to the acquisition of the cedant, which terminated the program. This assumed multi-peril crop and hail treaty reinsurance business covered revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects and disease. Additionally, we discontinued offering facultative reinsurance at the end of the third quarter of 2015 as a result of challenging market conditions.

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 completion of construction work of a commercial contractor for a specific project. Generally, losses occur due to the deterioration of a contractor's financial condition. This line has historically produced marginally higher loss ratios than other surety lines during economic downturns.

The insurance marketplace remains intensely competitive across all of our segments. New entrants, alternative capital and lower catastrophe activity in recent periods has had a significant impact on the industry. Despite these challenges in today's marketplace, we believe that our business model is built to create underwriting income by focusing on sound risk selection and discipline. Our primary focus will continue to be on underwriting profitability, with a secondary focus on premium growth where we believe underwriting profit exists, as opposed to general premium growth or market share measurements.

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

Throughout this quarterly report, we include certain non-generally accepted accounting principles ("non-GAAP") financial measures. Management believes that these non-GAAP measures better explain the Company's results of operations and allows for a more complete understanding of the underlying trends in the Company's business. These measures should not

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be viewed as a substitute for those determined in accordance with GAAP. In addition, our definitions of these items may not be comparable to the definitions used by other companies.

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

### Underwriting Income

Underwriting income or profit represents one measure of the pretax profitability of our insurance operations and is derived by subtracting losses and settlement expenses, policy acquisition costs and insurance operating expenses from net premiums earned, which are all GAAP financial measures. Each of these captions is presented in the statements of earnings, but is not subtotaled. However, this information is available in total and by segment in note 11 to the consolidated financial statements in our 2015 Annual Report on Form 10-K, regarding operating segment information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains/losses, general corporate expenses, debt costs and earnings from unconsolidated investees.

### Combined Ratio

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

### Net Unpaid Loss and Settlement Expenses

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

the process of establishing these various estimated amounts.

### Critical Accounting Policies

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

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation and OTTI, recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes. For a detailed discussion of each of these policies, refer to our 2015 Annual Report on Form 10-K. There have been no significant changes to any of these policies during the current year.

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## NINE MONTHS ENDED SEPTEMBER 30, 2016 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2015

Consolidated revenues, as displayed in the table that follows, totaled \$604.0 million for the first nine months of 2016 compared to \$587.3 million for the same period in 2015.

|                                      | For the Nine-Month<br>Periods<br>Ended September 30, |            |
|--------------------------------------|--|------------|
|                                      | 2016   | 2015       |
| Consolidated revenues (in thousands) |  |            |
| Net premiums earned                  | \$ 540,739   | \$ 520,790 |
| Net investment income                | 39,922   | 40,890     |
| Net realized gains                   | 23,362   | 25,622     |
| Total consolidated revenue           | \$ 604,023   | \$ 587,302 |

Consolidated revenue for the first nine months of 2016 increased \$16.7 million, or 3 percent, from the same period in 2015. Net premiums earned for the Group increased 4 percent, driven by growth from our casualty and surety segments, which were up 10 percent and 4 percent, respectively. Due to the current low yield environment, net investment income decreased 2 percent to \$39.9 million. Net realized gains totaled \$23.4 million, inclusive of a \$7.2 million non-cash goodwill impairment charge and \$0.1 million OTTI impairment loss of fixed income securities, in the first nine months of 2016, compared to \$25.6 million in 2015.

Net after-tax earnings for the first nine months of 2016 totaled \$82.7 million, \$1.86 per diluted share, compared to \$103.7 million, \$2.35 per diluted share, for the same period last year. Results for both periods reflected positive underwriting results for the current accident year and also benefited from favorable development on prior years' loss reserves. From a prior accident year standpoint, favorable development resulted in additional pretax earnings of \$29.1 million in the first nine months of 2016 compared to \$62.1 million in 2015. Underwriting results for both periods were impacted by losses from storm activity, which totaled \$8.3 million in the first nine months of 2016, compared to \$10.3 million for the same period last year. Bonus and profit sharing-related expenses related to prior year reserve development and storm losses totaled \$2.9 million in 2016, compared to \$7.6 million in 2015. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonus and profit-sharing amounts earned by executives, managers and associates are predominately influenced by corporate performance including operating earnings, combined ratio and return on capital.

During the first nine months of 2016, equity in earnings of unconsolidated investees totaled \$10.8 million. This amount includes \$9.9 million from Maui Jim and \$0.9 million from Prime. Comparatively, the first nine months of 2015 reflected \$11.0 million of earnings, including \$10.1 million from Maui Jim and \$0.9 million from Prime. The decline in Maui Jim earnings for 2016 was primarily due to larger unfavorable foreign exchange results, an impact



that was largely offset, when comparing earnings to 2015, by a non-recurring loss on the sale of an asset in 2015.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$116.6 million, \$2.63 per diluted share, for the first nine months of 2016, compared to \$55.0 million, \$1.25 per diluted share, for the first nine months of 2015. Unrealized gains, net of tax, in the first nine months of 2016 were \$33.9 million, compared to unrealized losses of \$48.7 million for the same period in 2015. Unrealized gains in the first nine months of 2016 were primarily due to a decline in interest rates, increasing the value of the fixed income portfolio, and were aided by positive pricing movements for equity securities. In 2015, unrealized losses were the result of rising interest rates and an underperforming equity market.

#### RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group increased 2 percent to \$668.5 million for the first nine months of 2016. Growth was driven by our casualty segment, which was up 8 percent, with our surety segment also having contributed to the improved top line. Gross premiums written from our property segment declined, however, as our exits from crop and facultative reinsurance and continued soft pricing for excess and surplus property coverages adversely impacted property results. Net premiums earned increased \$19.9 million, or 4 percent, due to overall growth experienced in recent periods. This growth is attributable to our casualty and surety segments, which posted increases in net premiums earned of 10 percent and 4 percent, respectively. Underwriting income for the Group totaled \$57.9 million for the first nine months of 2016, compared to \$86.1 million in 2015. Both periods reflect positive underwriting results for the current accident year and favorable reserve development on prior accident years. Favorable development on prior years' loss and catastrophe reserves improved net underwriting results by \$24.2 million in 2016, compared to \$52.9 million in 2015. The majority of the difference

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in the level of favorable development on prior years' reserves relates to our casualty segment. Underwriting results were also impacted by catastrophe losses, and while relatively modest for both periods on an overall basis, the net impact of losses in 2016 was \$1.8 million lower than the prior year. The GAAP combined ratio totaled 89.3 in 2016, compared to 83.4 in 2015. The loss ratio increased to 48.0 from 41.9, while the Group's expense ratio decreased to 41.3 from 41.5.

|                                       | For the Nine-Month<br>Periods<br>Ended September 30, |            |
|---------------------------------------|--|------------|
|                                       | 2016   | 2015       |
| Gross premiums written (in thousands) |  |            |
| Casualty                              | \$ 426,257   | \$ 393,596 |
| Property                              | 145,814  | 165,635    |
| Surety                                | 96,434   | 93,776     |
| Total                                 | \$ 668,505   | \$ 653,007 |
| Underwriting income (in thousands)    |  |            |
| Casualty                              | \$ 20,490  | \$ 38,124  |
| Property                              | 13,911   | 22,220     |
| Surety                                | 23,523   | 25,723     |
| Total                                 | \$ 57,924  | \$ 86,067  |
| Combined ratio                        |  |            |
| Casualty                              | 93.9   | 87.6       |
| Property                              | 87.8   | 82.6       |
| Surety                                | 73.9   | 70.4       |
| Total                                 | 89.3   | 83.4       |

## Casualty

Gross premiums written for the casualty segment increased 8 percent, to \$426.3 million for the first nine months of 2016, compared to \$393.6 million for the first nine months of 2015. Growth in the segment was led by transportation, which increased \$12.6 million (17 percent) to \$85.2 million as favorable pricing has continued to contribute to improved top line performance. Our medical professional liability business also increased significantly, up \$6.7 million (61 percent) in the first nine months of 2016. This growth was driven entirely by our recently launched healthcare liability offerings, and more than offset slight declines experienced in our other medical professional liability coverages. Our P&C package product posted gross premiums written of \$40.0 million, up 9 percent from prior year, while general liability and umbrella also delivered solid top line growth, up 7 percent, and 5 percent, respectively. Partially offsetting the growth from these products was a slight decline experienced in our executive products book, which fell 2 percent due to ongoing competitive pressures in this market.

The casualty segment recorded underwriting income of \$20.5 million in the first nine months of 2016, compared to \$38.1 million for the same period last year. Underwriting results for both periods reflect positive underwriting performance from a current accident year standpoint and benefited from favorable development on prior years' loss reserves. During the first nine months of 2016, we released reserves which improved the segment's underwriting results by \$17.8 million. Products with favorable development included general liability, executive products, P&C package, umbrella and professional services group, with the majority of the favorable development occurring on more recent accident years (2009-2015). Products with unfavorable development included transportation and medical professional liability, most of which was attributable to accident years 2013-2015. Comparatively, 2015 results included favorable development on prior accident years' loss reserves, primarily for general liability, umbrella, transportation, P&C package, executive products, professional services group and medical professional liability, which improved the segment's underwriting results by \$40.1 million.

Segment results for 2016 translated into a combined ratio of 93.9, compared to 87.6 in 2015. The segment's loss ratio was 59.2 in 2016, up from 52.1 in the prior year. The increase in the loss ratio for 2016 was driven by the decreased benefit from favorable development on prior years' reserves compared to 2015. The segment's expense ratio decreased slightly to 34.7 in 2016 from 35.5 in 2015.

#### Property

Gross premiums written for the Group's property segment totaled \$145.8 million for the first nine months of 2016, a decrease of \$19.8 million, or 12 percent, from the same period last year. The majority of this decline relates to our exit from

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crop and facultative reinsurance business, which declined \$9.6 million and \$3.4 million, respectively. Excluding the impact of these exited lines, property premiums declined 4 percent. The remaining premium decrease was driven by ongoing competitive pressures and price declines for excess and surplus commercial property coverages and re-underwriting efforts in our recreational vehicles book of business. Our commercial property business posted a premium decline of \$6.5 million (8 percent). The decrease from our recreational vehicles line totaled \$2.6 million (23 percent) for the first nine months of 2016, though growth from other specialty personal property coverages partially offset this decline. Excluding recreational vehicles, other specialty personal lines increased 17 percent as both newer and established products experienced growth.

Underwriting income for the segment was \$13.9 million for the first nine months of 2016, compared to \$22.2 million for the same period last year. Results for both periods reflect positive underwriting income for the current accident year and favorable development on prior years' loss and catastrophe reserves. Underwriting results for 2016 include a small amount of favorable development on prior years' loss and catastrophe reserves, primarily on marine and property reinsurance business, which improved the segment's underwriting results by \$0.5 million. This favorable development partially offset losses recorded on 2016 storms, which reduced the segment's underwriting results by \$6.7 million. Comparatively, underwriting results for 2015 included favorable development on prior years' loss and catastrophe reserves of \$5.0 million and \$8.7 million in storm losses.

Segment results for the first nine months of 2016 translated into a combined ratio of 87.8 compared to 82.6 for the same period last year. The segment's loss ratio increased to 43.6 in 2016 from 40.8 in 2015 due to the decreased benefit in 2016 from favorable development on prior years' loss and catastrophe reserves. The segment's expense ratio also increased for the first nine months of 2016, up 2.4 points to 44.2. The increased expense ratio relates to the overall decline in premium, due to the fixed nature of certain expenses, and shifts in product mix within the segment.

Surety

The surety segment recorded gross premiums written of \$96.4 million for the first nine months of 2016, an increase of \$2.7 million (3 percent), from the same period last year. Miscellaneous surety delivered solid top line results, up \$3.2 million (9 percent), while contract surety also performed well, achieving 5 percent growth in gross premiums written. Our commercial surety and energy surety products partially offset this growth, and posted declines of 6 percent and 2 percent, respectively.

The surety segment recorded underwriting income of \$23.5 million, down slightly from \$25.7 million for the same period last year. Both periods benefited from positive current accident year underwriting performance and favorable development on prior years' loss reserves. Results for 2016 included favorable development on prior accident years' loss reserves which improved the segment's underwriting results by \$7.0 million. This favorable development was partially offset by reinsurance reinstatement premium related to a ceded loss on prior years' contract surety business, which reduced premium and underwriting income by \$0.7 million. Overall, each of our surety lines experienced favorable development on prior years' reserves during 2016. Comparatively, 2015 results included favorable

development on prior accident years' loss reserves for each of our surety lines, which improved the segment's underwriting results by \$8.9 million.

The combined ratio for the surety segment totaled 73.9 for the first nine months of 2016, compared to 70.4 for the same period in 2015. The segment's loss ratio was 11.5 for 2016, compared to 8.0 for 2015, with the increase attributable to the lower benefit from favorable development on prior years' reserves in 2016. The expense ratio was 62.4 in 2016, unchanged from the prior year.

#### INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net investment income of \$39.9 million during the first nine months of 2016, a decrease of 2.4 percent from that reported for the same period in 2015. The decrease in investment income was due to a lower yield environment during the first nine months of 2016. On an after-tax basis, investment income decreased by 2.0 percent.

| (in thousands)                  | 9/30/2016            |         | 12/31/2015           |         |
|---------------------------------|----------------------|---------|----------------------|---------|
|                                 | Financial Stmt Value | %       | Financial Stmt Value | %       |
| Fixed income                    | \$ 1,687,605         | 79.6 %  | \$ 1,538,110         | 78.8 %  |
| Equity securities               | 382,282              | 18.1 %  | 375,424              | 19.2 %  |
| Other invested assets           | 24,502               | 1.2 %   | 20,666               | 1.1 %   |
| Cash and short-term investments | 22,362               | 1.1 %   | 17,343               | 0.9 %   |
| Total                           | \$ 2,116,751         | 100.0 % | \$ 1,951,543         | 100.0 % |

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

Yields on our fixed income investments for the first nine months of 2016 and 2015 were as follows:

|                 | 2016   | 2015   |
|-----------------|--------|--------|
| Pretax Yield    |        |        |
| Taxable         | 3.22 % | 3.38 % |
| Tax-Exempt      | 2.68 % | 2.78 % |
| After-Tax Yield |        |        |
| Taxable         | 2.09 % | 2.20 % |
| Tax-Exempt      | 2.54 % | 2.63 % |

The fixed income portfolio increased by \$149.5 million in the first nine months of 2016. The increase is due to allocating the majority of cash flows to the fixed income portfolio as well as the decline in interest rates through the first nine months of the year. This portfolio had a tax-adjusted total return on a mark-to-market basis of 5.7 percent. Average fixed income duration was 4.9 years at September 30, 2016, reflecting our current liability structure and sound capital position.

The equity portfolio increased by \$6.9 million during the first nine months of 2016, to \$382.3 million, and had a total return of 11.9 percent through September 30, 2016.

We recognized \$23.4 million of realized gains, inclusive of a \$7.2 million non-cash goodwill impairment charge and \$0.1 million other-than-temporary impairment loss of fixed income securities, in the first nine months of 2016, compared to realized gains of \$25.6 million in the same period of 2015. The majority of investing realized gains were taken in the equity portfolio.

The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of September 30, 2016, including fair value, cost basis and unrealized gains and losses.

| (in thousands) | 9/30/2016  |            | Unrealized |        | Net |
|----------------|------------|------------|------------|--------|-----|
|                | Cost Basis | Fair Value | Gains      | Losses |     |

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|                        |            |            |            |          |            |
|------------------------|------------|------------|------------|----------|------------|
| Consumer discretionary | \$ 7,405   | \$ 19,354  | \$ 11,949  | \$ —     | \$ 11,949  |
| Consumer staples       | 14,234     | 30,154     | 16,746     | (826)    | 15,920     |
| Energy                 | 16,897     | 29,917     | 13,020     | —        | 13,020     |
| Financials             | 26,941     | 43,266     | 16,428     | (103)    | 16,325     |
| Healthcare             | 5,164      | 16,975     | 11,811     | —        | 11,811     |
| Industrials            | 12,742     | 29,082     | 16,340     | —        | 16,340     |
| Information technology | 11,219     | 25,694     | 14,475     | —        | 14,475     |
| Materials              | 1,480      | 5,139      | 3,659      | —        | 3,659      |
| Telecommunications     | 3,193      | 10,680     | 7,487      | —        | 7,487      |
| Utilities              | 23,477     | 45,486     | 22,009     | —        | 22,009     |
| ETF                    | 77,843     | 126,535    | 48,692     | —        | 48,692     |
|                        | \$ 200,595 | \$ 382,282 | \$ 182,616 | \$ (929) | \$ 181,687 |

INCOME TAXES

Our effective tax rate for the first nine months of 2016 was 30.5 percent compared to 31.4 percent for the same period in 2015. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate was slightly lower for the first nine months of 2016. While the dollar amount of tax favored adjustments were similar year over year, they were slightly larger on a percentage basis due to lower levels of pre-tax earnings.

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## THREE MONTHS ENDED SEPTEMBER 30, 2016 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2015

Consolidated revenues, as displayed in the table that follows, totaled \$206.4 million for the third quarter of 2016, compared to \$200.9 million for the same period in 2015.

|                                      | For the Three-Month Periods<br>Ended September 30, |            |
|--------------------------------------|--|------------|
|                                      | 2016   | 2015       |
| Consolidated revenues (in thousands) |  |            |
| Net premiums earned                  | \$ 183,595   | \$ 179,448 |
| Net investment income                | 13,504   | 13,964     |
| Net realized gains                   | 9,252  | 7,534      |
| Total consolidated revenue           | \$ 206,351   | \$ 200,946 |

Consolidated revenue for the third quarter of 2016 increased \$5.4 million, or 3 percent, from the same period in 2015. Net premiums earned for the Group increased 2 percent for the quarter, driven by growth from our casualty and surety segments, while investment income declined slightly, down 3 percent. Net realized gains totaled \$9.3 million, inclusive of our \$0.1 million other-than-temporary impairment loss of fixed income securities, in the three month period ended September 30, 2016, compared to \$7.5 million in 2015.

Net after-tax earnings for the third quarter of 2016 totaled \$22.3 million, \$0.50 per diluted share, compared to \$35.9 million, \$0.81 per diluted share, for the same period last year. Results for 2016 reflected positive underwriting results for the current accident year which were slightly offset by unfavorable development on prior years' loss and catastrophe reserves and reinsurance reinstatement premium. The combined impact of the unfavorable development and reinstatement premium was \$1.5 million. Comparatively, for the third quarter of 2015, positive underwriting results on a current accident year basis were bolstered by \$18.6 million of favorable development on prior years' reserves. Both periods reflected losses from storm activity, which totaled \$4.0 million in the third quarter of 2016, compared to \$2.9 million for the same period last year. Bonus and profit sharing-related expenses recorded during the quarter were impacted by each of these items. For 2016, expenses declined by \$0.7 million in connection with the above mentioned items, while in 2015 an additional \$2.4 million of bonus and profit sharing expenses were recorded.

During the third quarter of 2016, equity in earnings of unconsolidated investees totaled \$1.9 million. This amount includes \$1.6 million from Maui Jim and \$0.3 million from Prime. Comparatively, the third quarter of 2015 reflected \$0.7 million of earnings, including \$0.5 million from Maui Jim and \$0.2 million from Prime. Maui Jim earnings for the third quarter of 2016 were higher than the prior year, due largely to a non-recurring loss on the sale of an asset which impacted results for 2015.



Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$15.3 million, \$0.34 per diluted share, for the third quarter of 2016, compared to \$19.8 million, \$0.45 per diluted share, for the third quarter of 2015. The third quarter's \$6.9 million other comprehensive loss was attributable to realized gains taken in the equity portfolio during the period, resulting in a lower net unrealized gain position. This compares to a \$16.1 million loss for the same period in 2015.

## RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group increased 3 percent to \$221.6 million for the third quarter of 2016. Growth achieved by our casualty segment, up 10 percent in the quarter, was offset by declines from our property and surety segments, which declined 8 percent and 2 percent, respectively. As disclosed in recent quarters, results from the property segment are impacted by our recent exits from crop and facultative reinsurance businesses. Excluding the impact of these exited lines, gross premiums written for the Group were up 5 percent. Results for the quarter reflect further price declines for excess and surplus commercial property coverages, which continued the recent trend of softening rates. Most of our other product offerings, however, experienced low to mid-single digit changes during the quarter. Net premiums earned increased \$4.1 million, or 2 percent. This growth was attributable to our casualty and surety segments, where net premiums earned were up 10 percent and 3 percent, respectively, from the prior year, and offset a 16 percent decline from the property segment. Underwriting income for the Group totaled \$10.6 million for the third quarter of 2016, compared to \$33.6 million in 2015, with results for each period reflecting positive underwriting performance for the current accident year. The disparity in underwriting results between periods relates primarily to development on prior accident year reserves. From a prior accident

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year standpoint, results for 2016 include unfavorable development and reinstatement premium which adversely impacted net underwriting income by \$1.4 million. Conversely, favorable development on prior years' loss and catastrophe reserves improved net underwriting results in the third quarter of 2015 by \$15.8 million. Storm losses also impacted both periods, yet were relatively modest. The net impact of storm losses in 2016 was \$0.9 million greater than the prior year. The GAAP combined ratio totaled 94.2 in 2016, compared to 81.3 in 2015. The loss ratio increased to 53.3 from 40.7, while the Group's expense ratio increased slightly to 40.9 from 40.6.

|                                       | For the Three-Month Periods<br>Ended September 30, |            |
|---------------------------------------|--|------------|
|                                       | 2016   | 2015       |
| Gross premiums written (in thousands) |  |            |
| Casualty                              | \$ 141,078   | \$ 128,804 |
| Property                              | 48,334   | 52,697     |
| Surety                                | 32,181   | 32,840     |
| Total                                 | \$ 221,593   | \$ 214,341 |
| Underwriting income (in thousands)    |  |            |
| Casualty                              | \$ 259   | \$ 13,651  |
| Property                              | 468  | 9,216      |
| Surety                                | 9,877  | 10,726     |
| Total                                 | \$ 10,604  | \$ 33,593  |
| Combined ratio                        |  |            |
| Casualty                              | 99.8   | 87.0       |
| Property                              | 98.7   | 79.4       |
| Surety                                | 67.5   | 63.8       |
| Total                                 | 94.2   | 81.3       |

## Casualty

Gross premiums written for the casualty segment increased 10 percent to \$141.1 million for the third quarter of 2016, compared to \$128.8 million for the third quarter of 2015. Most products within the segment posted top line growth, as expansion efforts, newer product initiatives and moderately improved pricing on certain coverages contributed to the increased premium production. Growth was led by our transportation unit, which posted its sixth consecutive quarter of double digit premium growth. Transportation has continued to capitalize on opportunities to write new and returning business, and has also benefited from favorable price changes in recent periods. Gross premiums written from transportation totaled \$30.0 million in the third quarter, up 24 percent from the prior year. Our medical professional liability business also contributed significantly to growth, as production increased \$1.5 million (49 percent) in the quarter. The increase was driven by our recently launched healthcare liability offerings, and served to more than offset slight declines from our other medical professional liability coverages. Other product lines achieving notable growth within the casualty segment included our umbrella coverages, up \$2.2 million (7 percent), and our professional services business, which advanced \$1.3 million (6 percent).

The casualty segment recorded underwriting income of \$0.3 million in the third quarter of 2016, compared to \$13.7 million for the same period last year. The disparity in underwriting profit between periods relates primarily to development on prior years' loss reserves. Results for 2016 reflect unfavorable development on prior years' reserves, compared to favorable development on prior years' reserves during 2015. As a result of our reserve study, we recorded adjustments to reserves during the third quarter of 2016 which adversely impacted the segment's net underwriting results by \$4.0 million. Products with unfavorable development included transportation and umbrella and to a lesser degree professional services and medical professional liability, with the majority of the unfavorable development occurring on accident years 2012 through 2015. For transportation and umbrella, the unfavorable development was driven primarily by an increase in the number of large claims occurring during the quarter. Given the relatively small size of our products, a modest change in the number of large claims can cause volatility in underwriting performance. The adverse development for these products was partially offset by favorable development on prior years' reserves for general liability, executive products and P&C package, most of which related to more recent accident years (2011–2015). Comparatively, 2015 results included favorable development on prior accident years' loss reserves, primarily for general liability, umbrella, P&C package and executive products. In total, favorable development improved the segment's net underwriting results in the third quarter of 2015 by \$11.5 million.

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Overall, the combined ratio for the casualty segment was 99.8 for 2016, compared to 87.0 in 2015. The segment's loss ratio was 65.7 in 2016, compared to 51.6 in 2015. The loss ratio increase in 2016 was due to the lower benefit from development on prior years' reserves in 2016, though the current accident year loss ratio did improve slightly from 2015. The expense ratio for the casualty segment was 34.1 for the third quarter of 2016, compared to 35.4 for the same period in 2015.

## Property

Gross premiums written for the Group's property segment totaled \$48.3 million for the third quarter of 2016, a \$4.4 million (8 percent) decrease from the same period last year. Approximately half of this decline related to our previously announced exits from crop and facultative reinsurance businesses, while the remaining premium decrease was driven largely by excess and surplus commercial property coverages. Our commercial property business posted \$23.8 million in gross written premium, down 8 percent, and continues to be impacted by increased competition and declining prices. Our specialty personal lines businesses increased slightly overall during the quarter, despite declines from the recreational vehicles program. Recreational vehicles posted a 19 percent decline from the same period last year, due to ongoing re-underwriting efforts. Excluding recreational vehicles, other specialty personal coverages increased 19 percent as both newer and established products experienced growth.

Underwriting income for the segment was \$0.5 million for the third quarter of 2016, compared to \$9.2 million for the same period last year. Both periods reflect positive underwriting income for the current accident year, though to a lesser extent in the third quarter of 2016 for the marine product. Underwriting results for 2016 include unfavorable development on prior years' loss and catastrophe reserves, primarily on marine business, which adversely impacted the segment's net underwriting results by \$1.3 million. Underwriting results for 2016 were also impacted by losses recorded on 2016 storms, which reduced the segment's net underwriting results by \$3.4 million. Comparatively, underwriting results for 2015 included favorable development on prior years' loss and catastrophe reserves which impacted net underwriting results by \$1.2 million and partially offset \$2.5 million in storm losses.

Underwriting results for the third quarter of 2016 translated into a combined ratio of 98.7, compared to 79.4 for the same period last year. The segment's loss ratio increased to 54.4 in 2016 from 40.0 in 2015. The increase was driven by the lower benefit from development on prior years' reserves, coupled with higher storm and other current accident year losses in 2016 as compared to 2015. The segment's expense ratio increased to 44.3 for the third quarter of 2016, up from 39.4 in the prior year. The increased expense ratio relates to shifts in product mix, in particular with regard to crop, which carried a very low acquisition expense rate, and the overall decline in net premium earned.

## Surety

The surety segment recorded gross premiums written of \$32.2 million for the third quarter of 2016, a decrease of \$0.7 million, or 2 percent, from the same period last year. The slight decrease this quarter represents the first quarterly decline in gross premiums written in nearly three years. Growth within the segment was achieved by miscellaneous surety, which was up 8 percent to \$12.4 million. The increase served to partially offset a 14 percent decline from commercial surety, in addition to slight declines from contract and energy surety.

The surety segment recorded underwriting income of \$9.9 million, compared to \$10.7 million for the same period last year. Both periods reflected positive underwriting performance from a current accident year standpoint and benefited from favorable development on prior years' loss reserves. Results for 2016 included favorable development on prior accident years' reserves, largely from energy surety, which improved the segments net underwriting results by \$4.4 million. This favorable development was partially offset by reinsurance reinstatement premium related to a ceded loss on prior years' contract surety business, which reduced premium and underwriting income by \$0.7 million. Comparatively, 2015 results included favorable development on prior accident years' loss reserves which impacted the segment's net underwriting results by \$3.5 million. All products within the segment experienced favorable development for each of these periods.

The combined ratio for the surety segment totaled 67.5 for the third quarter of 2016, compared to 63.8 for the same period in 2015. The segment's loss ratio was 5.1 for 2016, compared to 3.1 for 2015. The expense ratio increased slightly to 62.4 for the third quarter of 2016, up from 60.7 in the prior year, due to shifts in mix towards products with higher acquisition expenses and the above mentioned reinstatement premium.

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## INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net investment income of \$13.5 million during the third quarter of 2016, a decrease of 3.3 percent from that reported for the same period in 2015. The decrease in investment income was due to the lower yield environment from the previous year. On an after-tax basis, investment income decreased by 3.3 percent.

Our current equity allocation represents 18 percent of our total investment portfolio.

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

Yields on our fixed income investments for the third quarter of 2016 and 2015 were as follows:

|                 | 3Q 2016 |   | 3Q 2015 |   |
|-----------------|---------|---|---------|---|
| Pretax Yield    |         |   |         |   |
| Taxable         | 3.03    | % | 3.35    | % |
| Tax-Exempt      | 2.65    | % | 2.76    | % |
| After-Tax Yield |         |   |         |   |
| Taxable         | 1.97    | % | 2.18    | % |
| Tax-Exempt      | 2.51    | % | 2.61    | % |

We recognized \$9.3 million in realized gains, inclusive of our \$0.1 million OTTI loss of fixed income securities, in the third quarter of 2016, compared to realized gains of \$7.5 million in the same period of 2015. Realized gains were primarily taken from the equity portfolio.

## INCOME TAXES

Our effective tax rate for the third quarter of 2016 was 28.5 percent, compared to 30.9 percent for the same period in 2015. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate was slightly lower for the third quarter of 2016. While the dollar amount of tax favored adjustments were similar year

over year, they were slightly larger on a percentage basis due to lower levels of pre-tax earnings.

## LIQUIDITY AND CAPITAL RESOURCES

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

The following table summarizes cash flows provided by (used in) our activities for the nine-month periods ended September 30, 2016 and 2015:

|                      | 2016           | 2015         |
|----------------------|----------------|--------------|
|                      | (in thousands) |              |
| Operating cash flows | \$ 123,000     | \$ 121,367   |
| Investing cash flows | \$ (102,425)   | \$ (106,859) |
| Financing cash flows | \$ (17,686)    | \$ (16,940)  |
| Total                | \$ 2,889       | \$ (2,432)   |

Operating activities generated positive cash flows of \$123.0 million in the first nine months of 2016, compared to \$121.4 million in the same period last year. The increase in operating cash flows was due largely to an increase in premium written in 2016.

We have \$148.7 million in debt outstanding. On October 2, 2013, we completed a public debt offering, issuing \$150.0 million in senior notes maturing September 15, 2023 (a 10-year maturity), and paying interest semi-annually at the rate of 4.875 percent per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$148.6 million. The estimated fair value for the senior note at September 30, 2016 was \$158.7 million. The fair value of our debt is estimated based on the limited observable prices that reflect thinly traded securities.

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As of September 30, 2016, we had cash, short-term investments and other investments maturing within one year of approximately \$51.5 million and an additional \$365.9 million maturing between one to five years. As of September 30, 2016, our short-term investments were held primarily in government/agency funds. All funds are NAIC-rated, AAA-rated and maintain average weighted maturities of less than 60 days. Holdings within each of these funds comply with regulatory limitations.

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

We also maintain a revolving line of credit with JP Morgan Chase Bank N.A., which permits us to borrow up to an aggregate principal amount of \$40.0 million. This facility was entered into during the second quarter of 2014 and replaced the previous \$25.0 million facility which expired on May 31, 2014. Under certain conditions, the line may be increased up to an aggregate principal amount of \$65.0 million. The facility has a four-year term that expires on May 28, 2018. As of and during the nine-month period ended September 30, 2016, no amounts were outstanding on this facility.

Additionally, two of our insurance companies, RLI Ins. and Mt. Hawley, are members of the Federal Home Loan Bank of Chicago (FHLBC). Membership in the Federal Home Loan Bank System provides both companies access to an additional source of liquidity via a secured lending facility. Our membership allows each insurance subsidiary to determine tenor and structure at the time of borrowing. As of and during the nine-month period ended September 30 2016, there were no outstanding borrowing amounts with FHLBC.

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

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

We maintain a diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of September 30, 2016, our investment portfolio had a balance sheet value of \$2.1 billion. Invested assets at September 30, 2016, have increased \$165.2 million from December 31, 2015.



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As of September 30, 2016, our investment portfolio had the following asset allocation breakdown:

Portfolio Allocation  
(in thousands)

| Asset class                     | Cost or<br>Amortized Cost | Fair<br>Value | Unrealized<br>Gain/(Loss) | % of Total<br>Fair Value | Quality* |
|---------------------------------|---------------------------|---------------|---------------------------|--------------------------|----------|
| U.S. government                 | \$ 82,796                 | \$ 84,313     | \$ 1,517                  | 4.0                      | % AAA    |
| U.S. agency                     | 11,493                    | 12,300        | 807                       | 0.6                      | % AAA    |
| Non-U.S. govt. & agency         | 6,037                     | 6,000         | (37)                      | 0.3                      | % BBB+   |
| Agency MBS                      | 302,761                   | 312,085       | 9,324                     | 14.7                     | % AAA    |
| ABS/CMBS**                      | 116,156                   | 118,236       | 2,080                     | 5.6                      | % AAA    |
| Corporate                       | 563,045                   | 580,674       | 17,629                    | 27.4                     | % BBB+   |
| Municipal                       | 542,580                   | 573,997       | 31,417                    | 27.1                     | % AA     |
| Total Fixed Income              | \$ 1,624,868              | \$ 1,687,605  | \$ 62,737                 | 79.7                     | % AA-    |
| Equity                          | \$ 200,595                | \$ 382,282    | \$ 181,687                | 18.1                     | %        |
| Other Invested Assets           | \$ 24,502                 | \$ 24,502     | \$ —                      | 1.2                      | %        |
| Cash and Short-Term Investments | \$ 22,362                 | \$ 22,362     | \$ —                      | 1.0                      | %        |
| Total Portfolio                 | \$ 1,872,327              | \$ 2,116,751  | \$ 244,424                | 100.0                    | %        |

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

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

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Our investment portfolio does not have any exposure to derivatives.

As of September 30, 2016, our fixed income portfolio had the following rating distribution:

|       |       |   |
|-------|-------|---|
| AAA   | 37.1  | % |
| AA    | 26.8  | % |
| A     | 18.0  | % |
| BBB   | 12.1  | % |
| BB    | 2.9   | % |
| B     | 2.6   | % |
| CCC   | 0.2   | % |
| NR    | 0.3   | % |
| Total | 100.0 | % |

As of September 30, 2016, the duration of the fixed income portfolio was 4.9 years. Our fixed income portfolio remained well diversified, with 1,111 individual issues as of September 30, 2016.

Our investment portfolio has limited exposure to structured asset-backed securities (ABS). As of September 30, 2016, we had \$78.8 million in ABS which are pools of assets collateralized by cash flows from several types of loans, including home equity, credit cards, autos and similar obligations.

As of September 30, 2016, we had \$39.4 million in commercial mortgage backed securities (CMBS) and \$312.1 million in residential mortgage backed securities backed by government sponsored enterprises (GSEs - Freddie Mac, Fannie Mae and Ginnie Mae). Excluding the GSE backed MBS, our exposure to ABS and CMBS was 5.6 percent of our investment portfolio at quarter end.

We had \$580.7 million in corporate fixed income securities as of September 30, 2016. As of September 30, 2016, we had \$70.1 million invested in a high yield credit strategy. This portfolio consists of floating rate bank loans and bonds that are below investment grade in credit quality and offer incremental yield over our core fixed income portfolio.

We also maintain an allocation to municipal fixed income securities. As of September 30, 2016, we had \$574.0 million in municipal securities. As of September 30, 2016, approximately 90 percent of our municipal bond portfolio maintains an 'AA' or better rating, while 99 percent of the municipal bond portfolio is rated 'A' or better.

At September 30, 2016, our equity portfolio had a fair value of \$382.3 million and is also a source of liquidity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. In the equity portfolio, the strategy remains one of value investing, with security selection taking precedence over market timing. We use a buy-and-hold strategy, minimizing both transactional costs and taxes.

As of September 30, 2016, our equity portfolio had a dividend yield of 2.8 percent, compared to 2.1 percent for the S&P 500 index. Because of the corporate dividend-received-deduction applicable to our dividend income, we pay an effective tax rate of 14.2 percent on dividends, compared to 35.0 percent on taxable interest and 5.3 percent on municipal bond interest income. The equity portfolio is managed in a diversified and granular manner, with 83 individual names and no single stock exposure greater than 2 percent of the equity portfolio.

Other invested assets include three investments in low income housing tax credit partnerships (LIHTC), carried at amortized cost, membership in the Federal Home Loan Bank of Chicago (FHLBC), carried at cost, and an investment in a real estate fund, carried at cost. Due to the nature of the LIHTC and our membership in the FHLBC, their carrying amounts approximate fair value. Our LIHTC interests had a balance of \$17.9 million at September 30, 2016, compared to \$14.0 million at December 31, 2015 and recognized a total tax benefit of \$0.4 million during the third quarter of 2016 compared to \$0.3 million during the third quarter of 2015. For the nine-month period ended September 30, 2016 and 2015, our LIHTC interests recognized a total tax benefit of \$1.2 and \$0.8, respectively. Our investment in FHLBC stock totaled \$1.6 million at September 30, 2016 and December 31, 2015. Our investment in the real estate fund was carried at \$5.0 million and had a fair value of \$5.1 million at September 30, 2016, compared to a carrying value of \$5.0 million, which approximated fair value, at December 31, 2015.

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Our capital structure is comprised of equity and debt outstanding. As of September 30, 2016, our capital structure consisted of \$148.7 million in 10-year maturity senior notes maturing in 2023 (debt) and \$922.4 million of shareholders' equity. Debt outstanding comprised 13.9 percent of total capital as of September 30, 2016. Interest and fees on debt obligations totaled \$5.6 million during the first nine months of 2016, the same amount as the previous year. We have incurred interest expense on debt at an average annual interest rate of 4.91 percent for the nine-month periods ended September 30, 2016 and 2015.

We paid a quarterly cash dividend of \$0.20 per share on September 19, 2016, the same amount as the prior quarter. We have paid dividends for 161 consecutive quarters and increased dividends in each of the last 41 years.

Our insurance subsidiaries are organized in a vertical structure with RLI Ins. as the first-level, or principal, insurance subsidiary of RLI Corp. At the holding company (RLI Corp.) level, we rely largely on dividends from our insurance company subsidiaries to meet our obligations for paying principal and interest on outstanding debt, corporate expenses and dividends to RLI Corp. shareholders. As discussed further below, dividend payments to RLI Corp. from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the insurance regulatory authorities of Illinois. As a result, we may not be able to receive dividends from such subsidiary at times and in amounts necessary to pay desired dividends to RLI Corp. shareholders. On a GAAP basis, as of September 30, 2016, our holding company had \$922.4 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 \$57.6 million in liquid assets, which exceeds our estimated annual holding company expenditures of approximately \$45.0 million. Unrestricted funds at the holding company are available to fund debt interest, general corporate obligations and dividend payments to our shareholders. If necessary, the holding company also has other potential sources of liquidity that could provide for additional funding to meet corporate obligations or pay shareholder dividends, which include a revolving line of credit, as well as issuances of common stock and debt.

Ordinary dividends, which may be paid by our principal insurance subsidiary without prior regulatory approval, are subject to certain limitations based upon statutory income, surplus and earned surplus. The maximum ordinary dividend distribution from our principal insurance subsidiary in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Ins. policyholder surplus, as of December 31 of the preceding year, or the net income of RLI Ins. for the 12-month period ending December 31 of the preceding year. Ordinary dividends are further restricted by the requirement that they be paid from earned surplus. Any dividend distribution in excess of the ordinary dividend limits is deemed extraordinary and requires prior approval from the Illinois Department of Insurance. In the first nine months of 2016, RLI Ins. paid a total of \$39.6 million in ordinary dividends to RLI Corp. In 2015, our principal insurance subsidiary paid ordinary dividends totaling \$125.0 million to RLI Corp. No extraordinary dividends were paid during 2016 or 2015. As of September 30, 2016, \$53.6 million of the net assets of our principal insurance subsidiary are not restricted and could be distributed to RLI Corp. as ordinary dividends. Because the limitations are based upon a rolling 12-month period, the presence, amount and impact of these restrictions vary over time.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of economic losses due to adverse changes in the estimated fair value of a financial instrument as the result of changes in equity prices, interest rates, foreign currency exchange rates and commodity prices. Historically, our primary market risks have been equity price risk associated with investments in equity securities and interest rate risk associated with investments in fixed maturities. We have limited exposure to both foreign currency risk and commodity risk.

Credit risk is the potential loss resulting from adverse changes in an issuer's ability to repay its debt obligations. We monitor our portfolio to ensure that credit risk does not exceed prudent levels. We have consistently invested in high credit quality, investment grade securities. Our fixed maturity portfolio has an average rating of "AA-," with 82 percent rated "A" or better by at least two nationally recognized rating organizations.

On an overall basis, our exposure to market risk has not significantly changed from that reported in our December 31, 2015 Annual Report on Form 10-K.

#### ITEM 4. Controls and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures was

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performed, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective, as of the end of the period covered by this report.

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

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

PART II - OTHER INFORMATION

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

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

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

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

In 2010, our Board of Directors implemented a \$100 million share repurchase program. We did not repurchase any shares during 2016. We have \$87.5 million of remaining capacity from the repurchase program. The repurchase program may be suspended or discontinued at any time without prior notice.

Item 3. Defaults Upon Senior Securities - Not Applicable.

Item 4. Mine Safety Disclosures - Not Applicable.

Item 5. Other Information - Not Applicable.

Item 6. Exhibits

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

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

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

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

Exhibit 101 XBRL-Related Documents

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SIGNATURES

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

RLI Corp.

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

Date: October 24, 2016