

RLI CORP
Form 10-Q
October 28, 2009

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, 2009

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

(State or other jurisdiction of
incorporation or organization)

37-0889946
(I.R.S. Employer
Identification Number)

9025 North Lindbergh Drive, Peoria, IL
(Address of principal executive offices)

61615
(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
(Do not check if a smaller reporting company)

Smaller reporting company

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of October 15, 2009, the number of shares outstanding of the registrant's Common Stock was 21,628,875.

PART I - FINANCIAL INFORMATION

Item 1. 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 Three-Month Periods Ended September 30,	
	2009	2008 (1)
Net premiums earned	\$ 122,736	\$ 130,850
Net investment income	16,295	19,844
Net realized investment gains	6,985	7,960
Other-than-temporary impairment losses on investments(1)		(32,172)
Consolidated revenue	146,016	126,482
Losses and settlement expenses	47,677	66,013
Policy acquisition costs	41,627	41,424
Insurance operating expenses	10,480	8,216
Interest expense on debt	1,512	1,646
General corporate expenses	2,177	1,735
Total expenses	103,473	119,034
Equity in earnings of unconsolidated investee	1,120	248
Earnings before income taxes	43,663	7,696
Income tax expense (benefit)	12,644	(890)
Net earnings	\$ 31,019	\$ 8,586
Other comprehensive earnings (loss), net of tax	36,969	(24,109)
Comprehensive earnings (loss)	\$ 67,988	\$ (15,523)
Earnings per share:		
Basic:		
Basic net earnings per share	\$ 1.43	\$ 0.40
Basic comprehensive earnings per share	\$ 3.14	\$ (0.73)
Diluted:		
Diluted net earnings per share	\$ 1.42	\$ 0.40
Diluted comprehensive earnings per share	\$ 3.12	\$ (0.72)
Weighted average number of common shares outstanding		
Basic	21,622	21,342
Diluted	21,769	21,678
Cash dividends declared per common share	\$ 0.27	\$ 0.25

(1) There were no OTTI losses recognized in AOCI in the periods presented. 2008 amounts were reclassified to conform to current period presentation.

The accompanying notes are an integral part of the unaudited 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 Ended September 30,	
	2009	2008 (1)
Net premiums earned	\$ 370,910	\$ 399,110
Net investment income	50,494	58,707
Net realized investment gains	24,442	25,350
Other-than-temporary impairment losses on investments(1)	(45,231)	(37,746)
Consolidated revenue	400,615	445,421
Losses and settlement expenses	157,678	190,043
Policy acquisition costs	121,196	121,721
Insurance operating expenses	28,814	28,346
Interest expense on debt	4,537	5,191
General corporate expenses	5,847	5,759
Total expenses	318,072	351,060
Equity in earnings of unconsolidated investee	5,242	6,417
Earnings before income taxes	87,785	100,778
Income tax expense	24,502	28,083
Net earnings	\$ 63,283	\$ 72,695
Other comprehensive earnings (loss), net of tax	63,357	(68,274)
Comprehensive earnings	\$ 126,640	\$ 4,421
Earnings per share:		
Basic:		
Basic net earnings per share	\$ 2.93	\$ 3.37
Basic comprehensive earnings per share	\$ 5.86	\$ 0.20
Diluted:		
Diluted net earnings per share	\$ 2.91	\$ 3.32
Diluted comprehensive earnings per share	\$ 5.82	\$ 0.20
Weighted average number of common shares outstanding		
Basic	21,599	21,574
Diluted	21,759	21,893
Cash dividends declared per common share	\$ 0.80	\$ 0.73

(1) There were no OTTI losses recognized in AOCI in the periods presented. 2008 amounts were reclassified to conform to current period presentation.

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RLI Corp. and Subsidiaries Condensed Consolidated Balance Sheets

(in thousands, except share data)	September 30, 2009 (unaudited)	December 31, 2008
ASSETS		
Investments		
Fixed income		
Available-for-sale, at fair value	\$ 1,295,233	\$ 1,224,215
Held-to-maturity, at amortized cost	178,731	39,821
Trading, at fair value	1,068	10,020
Equity securities, at fair value	238,590	286,790
Short-term investments, at cost	142,771	97,982
Total investments	1,856,393	1,658,828
Accrued investment income	15,598	17,226
Premiums and reinsurance balances receivable	86,033	92,149
Ceded unearned premium	66,417	65,977
Reinsurance balances recoverable on unpaid losses	343,377	350,284
Deferred policy acquisition costs	79,923	78,520
Property and equipment	19,592	21,565
Income taxes-deferred		24,141
Investment in unconsolidated investees	44,348	38,697
Goodwill	26,214	26,214
Other assets	25,063	45,800
TOTAL ASSETS	\$ 2,562,958	\$ 2,419,401
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and settlement expenses	\$ 1,159,025	\$ 1,159,311
Unearned premiums	330,629	335,170
Reinsurance balances payable	22,844	30,224
Income taxes-deferred	26,089	
Bonds payable, long-term debt	100,000	100,000
Accrued expenses	36,327	32,894
Other liabilities	61,100	53,648
TOTAL LIABILITIES	\$ 1,736,014	\$ 1,711,247
Shareholders Equity		
Common stock (\$1 par value)		
(32,157,159 shares issued at 9/30/09)		
(32,106,085 shares issued at 12/31/08)	32,157	32,106
Paid-in capital	205,859	196,989
Accumulated other comprehensive earnings	78,485	15,130
Retained earnings	853,184	807,195
Deferred compensation	7,846	8,312
Less: Treasury shares at cost		
(10,528,284 shares at 9/30/09)	(350,587)	(351,578)
(10,631,656 shares at 12/31/08)		
TOTAL SHAREHOLDERS EQUITY	826,944	708,154
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 2,562,958	\$ 2,419,401

The accompanying notes are an integral part of the unaudited interim financial statements.

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)	For the Nine-Month Period Ended September 30,	
	2009	2008
Net cash provided by operating activities	\$ 108,445	\$ 126,732
Cash Flows from Investing Activities		
Investments purchased	(776,811)	(496,511)
Investments sold	334,386	141,378
Investments called or matured	353,230	306,973
Net change in short-term investments	(11,695)	13,762
Net property and equipment purchased	(507)	(4,632)
Net cash used in investing activities	\$ (101,397)	\$ (39,030)
Cash Flows from Financing Activities		
Cash dividends paid	\$ (16,494)	\$ (15,406)
Payment on short-term debt		(81,992)
Proceeds from issuance of short-term debt		54,017
Stock option plan share issuance	3,441	(79)
Excess tax benefit from exercise of stock options	257	3,663
Treasury shares reissued	5,748	
Treasury shares purchased		(47,905)
Net cash used in financing activities	\$ (7,048)	\$ (87,702)
Net increase in cash		
Cash at the beginning of the year		
Cash at September 30	\$	\$

The accompanying notes are an integral part of the unaudited interim financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. BASIS OF PRESENTATION

The unaudited condensed consolidated 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 2008 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, 2009 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 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 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 from these estimates.

B. ADOPTED ACCOUNTING STANDARDS

FASB Accounting Standards Codification

On July 1, 2009, the FASB Accounting Standards Codification (ASC) became the single official source of authoritative, nongovernmental GAAP, superseding existing FASB, AICPA, EITF, and related literature. Prospectively, only one level of authoritative GAAP will exist, excluding the guidance issued by the Securities and Exchange Commission (SEC). All other literature will be non-authoritative. The Codification does not change GAAP but instead reorganizes the U.S. GAAP pronouncements into accounting Topics, and displays all Topics using a consistent structure. As the Codification does not change GAAP, it did not have a material impact on our financial statements. The Codification was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. Previous references to applicable literature via our disclosures have been updated with references to the new Codification section.

FASB ASC 805, Business Combinations (previously SFAS No. 141(R), Business Combinations)

On January 1, 2009, we adopted GAAP guidelines in regard to business combinations. Assets and liabilities that arose from business combinations which occurred prior to the adoption of the most recent standard are not adjusted upon the adoption. Among other things, the recent standard broadens the scope of the previous guidance to include all transactions where an acquirer obtains control of one or more other

businesses. It retains the

guidance to recognize intangible assets separately from goodwill and requires, with limited exceptions, that all assets acquired and liabilities assumed, including certain contractual contingencies, be measured at their acquisition date fair values. Recent guidelines require most acquisition and restructuring related costs to be expensed as incurred. Step acquisitions, once control is acquired, are to be recorded at the full amounts of the fair values of the identifiable assets, liabilities and the non-controlling interest in the acquiree. The guidelines also replace the reduction of asset values and recognition of negative goodwill with a requirement to recognize a gain in earnings. The adoption had no impact on our financial position or results of operations. We will apply the provisions as applicable.

FASB ASC 350, Intangibles - Goodwill and Other (previously FSP No. 142-3, Determination of the Useful Life of Intangible Assets)

New GAAP guidance regarding the useful life of intangible assets became effective January 1, 2009. It amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under previous guidance. The intent of the new guidance is to improve the consistency between the useful life of a recognized intangible asset under FASB ASC 350 (previously SFAS 142) and the period of expected cash flows used to measure the fair value of the asset under FASB ASC 805 (previously SFAS 141(R)) and other generally accepted accounting principles. This new guidance applies to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. The implementation of this new guidance did not have a significant impact on our financial position or results of operations.

FASB ASC 320-10-65, Debt and Equity Securities - Transition and Open Effective Date Information (previously FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments)

In April 2009, the FASB issued new guidance on the recognition and presentation of other-than-temporary impairments (OTTI) which amends the recognition guidance for OTTI of debt securities and expands the financial statement disclosures for OTTI on debt and equity securities. We adopted this new guidance in the second quarter of 2009.

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

The guidance requires that companies record, as of the beginning of the interim period of adoption, a cumulative-effect adjustment to reclassify the noncredit component of a previously recognized OTTI loss from retained earnings to other comprehensive income if the company does not intend to sell the security and it is more-likely-than-not that the company will not be required to sell the security before recovery of its amortized cost basis. The adoption had no impact on our financial position or results of operations.

We had no cumulative-effect adjustment upon adoption at the beginning of the second quarter given our intent to sell securities with previously recognized OTTI losses, the majority of which were exited during the second quarter.

FASB ASC 820-10-65-4, Fair Value Measurements and Disclosures Transition and Open Effective Date Information (previously FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly)

In April 2009, the FASB issued new guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. Our adoption of this new guidance was effective April 1, 2009. The guidelines reaffirm that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The guidelines also reaffirm the need to use judgment in determining if a formerly active market has become inactive and in determining fair values when the market has become inactive. The adoption did not impact our financial position or results of operations.

FASB ASC 825-10-65-1, Financial Instruments Transition and Open Effective Date Information (previously FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments)

In April 2009, the FASB issued new guidance regarding interim disclosures about fair value of financial instruments. The new guidelines require disclosing qualitative and quantitative information about the fair value of all financial instruments on a quarterly basis, including methods and significant assumptions used to estimate fair value during the period. These disclosures were previously only done annually. The disclosures required by the guidelines are effective for the quarter ending June 30, 2009 and are included in note 2 to the unaudited condensed consolidated financial statements, Investments , and in the Liquidity and Capital Resources section of Management s Discussion and Analysis of Financial Condition and Results of Operations.

FASB ASC 855, Subsequent Events (previously SFAS No. 165, Subsequent Events)

In May 2009, the FASB issued new guidance regarding subsequent events which established general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are

issued or are available to be issued. The new standard provides guidance on the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. We adopted the new guidance during the second quarter of 2009, and its application had no impact on our condensed consolidated financial statements. We evaluated subsequent events through the date the accompanying financial statements were issued, which was October 28, 2009.

C. PROSPECTIVE ACCOUNTING STANDARDS

SFAS No. 166, Accounting for Transfers of Financial Assets (SFAS 166) and SFAS No. 167, Amendments to FASB Interpretation No. 46(R) (SFAS 167)

In June 2009, the FASB issued SFAS 166, *Accounting for Transfers of Financial Assets* and SFAS 167, *Amendments to FASB Interpretation No. 46(R)*, which update accounting for securitizations and special-purpose entities. SFAS 166 is a revision to FASB ASC 860, *Transfers and Servicing* (previously SFAS 140) and will require additional information regarding financial asset transfers, including securitization transactions, and the presence of continuing exposure around the risks related to transferred financial assets. It removes the concept of a qualifying special-purpose entity from FASB ASC 810, *Consolidation* (previously SFAS 140) and removes the exception from applying FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, to variable interest entities that are qualifying special-purpose entities. SFAS 167 is a revision to FASB Interpretation No. 46(R) and modifies a Company's determination of consolidating an entity that is insufficiently capitalized or is not controlled through voting or similar ownership rights. SFAS 166 and 167 will be effective January 1, 2010, and are effective for interim periods within the first annual reporting period. Earlier application is prohibited. We do not expect the implementation of SFAS 166 or 167 to have a significant impact on our financial statements.

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, which relates to our surety segment, is listed separately on the balance sheet and totaled \$26.2 million at September 30, 2009 and December 31, 2008. Annual impairment testing was performed during the second quarter of 2009. Based upon this review, this asset was not impaired. In addition, as of September 30, 2009, there were no triggering events that had occurred that would suggest an updated review was necessary.

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.

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

(in thousands, except per share data)	For the Three-Month Period Ended September 30, 2009			For the Three-Month Period Ended September 30, 2008		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	\$ 31,019	21,622	\$ 1.43	\$ 8,586	21,342	\$ 0.40
Effect of Dilutive Securities						
Stock Options		147			336	
Diluted EPS						
Income available to common shareholders	\$ 31,019	21,769	\$ 1.42	\$ 8,586	21,678	\$ 0.40

(in thousands, except per share data)	For the Nine-Month Period Ended September 30, 2009			For the Nine-Month Period Ended September 30, 2008		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	\$ 63,283	21,599	\$ 2.93	\$ 72,695	21,574	\$ 3.37
Effect of Dilutive Securities						
Stock Options		160			319	
Diluted EPS						
Income available to common shareholders	\$ 63,283	21,759	\$ 2.91	\$ 72,695	21,893	\$ 3.32

2. INVESTMENTS

Our investments include fixed income debt securities and common stock equity securities. As disclosed in our 2008 Annual Report on Form 10-K, we present our investments in the above classes as either available-for-sale, held-to-maturity, or trading securities. 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 financial statements, Fair Value Measurements.

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, 2009 and December 31, 2008. 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, 2009 and December 31, 2008, unrealized losses, as shown in the following tables, were less than 1% and 4%, respectively, of total invested assets. Unrealized losses have decreased in 2009, as the capital markets and general market conditions have continued to improve throughout 2009.

Investment Positions with Unrealized Losses
Segmented by Type and Period of Continuous
Unrealized Loss at September 30, 2009

(dollars in thousands)	0-12 Mos.	> 12 Mos.	Total
U.S Government			
Fair value	\$ 944	\$	\$ 944
Cost or Amortized Cost	944		944
Unrealized Loss			
U.S Agency			
Fair value	\$ 72,743	\$	\$ 72,743
Cost or Amortized Cost	73,641		73,641
Unrealized Loss	(898)		(898)
Mortgage-backed			
Fair value	\$ 15,019	\$	\$ 15,019
Cost or Amortized Cost	15,094		15,094
Unrealized Loss	(75)		(75)
ABS/CMO*			
Fair value	\$ 3,934	\$ 14,481	\$ 18,415
Cost or Amortized Cost	3,936	15,165	19,101
Unrealized Loss	(2)	(684)	(686)
Corporate			
Fair value	\$ 4,982	\$ 33,664	\$ 38,646
Cost or Amortized Cost	4,991	34,958	39,949
Unrealized Loss	(9)	(1,294)	(1,303)
States, political subdivisions & revenues			
Fair value	\$ 1,886	\$ 6,142	\$ 8,028
Cost or Amortized Cost	1,886	6,178	8,064
Unrealized Loss		(36)	(36)
Subtotal, debt securities			
Fair value	\$ 99,508	\$ 54,287	\$ 153,795
Cost or Amortized Cost	100,492	56,301	156,793
Unrealized Loss	(984)	(2,014)	(2,998)
Common Stock			
Fair value	\$ 19,927	\$ 5,606	\$ 25,533
Cost or Amortized Cost	21,350	5,989	27,339
Unrealized Loss	(1,423)	(383)	(1,806)
Total			
Fair value	\$ 119,435	\$ 59,893	\$ 179,328
Cost or Amortized Cost	121,842	62,290	184,132
Unrealized Loss	(2,407)	(2,397)	(4,804)

* Asset-backed & collateralized mortgage obligations.

This table excludes securities with a fair value of \$1 million classified as trading.

Investment Positions with Unrealized Losses**Segmented by Type and Period of Continuous****Unrealized Loss at December 31, 2008**

(dollars in thousands)	0-12 Mos.	> 12 Mos.	Total
U.S Government			
Fair value	\$	\$	\$
Cost or Amortized Cost			
Unrealized Loss			
U.S Agency			
Fair value	\$ 34,955	\$	\$ 34,955
Cost or Amortized Cost	35,379		35,379
Unrealized Loss	(424)		(424)
Mortgage-backed			
Fair value	\$ 62	\$	\$ 62
Cost or Amortized Cost	62		62
Unrealized Loss			
ABS/CMO *			
Fair value	\$ 38,489	\$ 16,721	\$ 55,210
Cost or Amortized Cost	41,707	19,495	61,202
Unrealized Loss	(3,218)	(2,774)	(5,992)
Corporate			
Fair value	\$ 135,865	\$ 32,737	\$ 168,602
Cost or Amortized Cost	149,935	38,707	188,642
Unrealized Loss	(14,070)	(5,970)	(20,040)
States, political subdivisions & revenues			
Fair value	\$ 133,515	\$ 13,250	\$ 146,765
Cost or Amortized Cost	137,660	13,970	151,630
Unrealized Loss	(4,145)	(720)	(4,865)
Subtotal, debt securities			
Fair value	\$ 342,886	\$ 62,708	\$ 405,594
Cost or Amortized Cost	364,743	72,172	436,915
Unrealized Loss	(21,857)	(9,464)	(31,321)
Common Stock			
Fair value	\$ 83,406	\$ 11,912	\$ 95,318
Cost or Amortized Cost	106,540	16,076	122,616
Unrealized Loss	(23,134)	(4,164)	(27,298)
Preferred Stock			
Fair value	\$ 2,613	\$	\$ 2,613
Cost or Amortized Cost	2,871		2,871
Unrealized Loss	(258)		(258)
Total			
Fair value	\$ 428,905	\$ 74,620	\$ 503,525
Cost or Amortized Cost	474,154	88,248	562,402

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Unrealized Loss	(45,249)	(13,628)	(58,877)
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* Asset-backed & collateralized mortgage obligations.

This table excludes securities with a fair value of \$10 million, classified as trading.

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The following tables show the amortized cost, unrealized gains/losses, fair value and contractual maturities for our available-for-sale and held-to-maturity securities.

Available-for-Sale Securities

The amortized cost and fair value of securities available-for-sale at September 30, 2009 and December 31, 2008 were as follows:

Available-for-sale

(in thousands)

Asset Class	9/30/2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Agencies	\$ 159,564	\$ 1,681	\$ (280)	\$ 160,965
Corporates	381,759	20,546	(1,303)	401,002
Mortgage-backed	243,130	7,881	(75)	250,936
Asset-backed	60,817	1,743	(686)	61,874
Treasuries	6,397	290		6,687
Munis	395,541	18,264	(36)	413,769
Total Fixed Income	\$ 1,247,208	\$ 50,405	\$ (2,380)	\$ 1,295,233

Available-for-sale

(in thousands)

Asset Class	12/31/2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Agencies	\$ 285,937	\$ 2,664	\$ (424)	\$ 288,177
Corporates	287,557	2,647	(20,040)	270,164
Mortgage-backed	164,315	4,202		168,517
Asset-backed	68,960	37	(5,992)	63,005
Treasuries	6,597	468		7,065
Munis	423,311	8,841	(4,865)	427,287
Total Fixed Income	\$ 1,236,677	\$ 18,859	\$ (31,321)	\$ 1,224,215

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The following table presents the amortized cost and fair value of available-for-sale debt securities by contractual maturity dates as of September 30, 2009, and December 31, 2008:

(in thousands)	9/30/2009		12/31/2008	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Agencies				
Due within 1 year	\$	\$	\$ 3,000	\$ 3,012
After 1 but within 5 years	22,363	22,631	9,616	9,852
After 5 but within 10 years	53,424	53,724	115,812	116,919
After 10 years*	83,777	84,610	157,509	158,394
Total	159,564	160,965	285,937	288,177
Corporates				
Due within 1 year	\$ 8,511	\$ 8,578	\$ 5,005	\$ 5,032
After 1 but within 5 years	130,468	137,143	88,679	86,060
After 5 but within 10 years	229,063	241,590	177,290	164,187
After 10 years	13,717	13,691	16,583	14,885
Total	381,759	401,002	287,557	270,164
Mortgage-backed				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years	6,971	7,326	7,725	7,931
After 10 years*	236,159	243,610	156,590	160,586
Total	243,130	250,936	164,315	168,517
Asset-backed				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years	3,446	3,615	6,154	6,101
After 5 but within 10 years	8,375	9,121	11,872	11,770
After 10 years*	48,996	49,138	50,934	45,134
Total	60,817	61,874	68,960	63,005
Treasuries				
Due within 1 year	\$	\$	\$ 1,105	\$ 1,138
After 1 but within 5 years	6,397	6,687	5,492	5,927
After 5 but within 10 years				
After 10 years*				
Total	6,397	6,687	6,597	7,065
Munis				
Due within 1 year	\$ 11,986	\$ 12,143	\$ 7,207	\$ 7,283
After 1 but within 5 years	98,599	104,043	143,270	148,393
After 5 but within 10 years	121,247	127,358	129,945	132,987
After 10 years*	163,709	170,225	142,889	138,624
Total	395,541	413,769	423,311	427,287
TOTAL	\$ 1,247,208	\$ 1,295,233	\$ 1,236,677	\$ 1,224,215

* Investments with no stated maturities are included as contractual maturities of greater than 10 years. Actual maturities may differ due to call or prepayment rights.

Held-to-Maturity Debt Securities

The carrying value and fair value of held-to-maturity securities at September 30, 2009 and December 31, 2008 were as follows:

Held-to-maturity

(in thousands)

Asset Class	Amortized Cost/ Carrying Value*	9/30/2009		Fair Value
		Gross Unrecognized Gains	Gross Unrecognized Losses	
Agencies	\$ 162,639	\$ 1,247	\$ (618)	\$ 163,268
Corporates				
Mortgage-backed				
Asset-backed				
Treasuries				
Munis	16,092	459		16,551
Total Fixed Income	\$ 178,731	\$ 1,706	\$ (618)	\$ 179,819

Held-to-maturity

(in thousands)

Asset Class	Amortized Cost/ Carrying Value*	12/31/2008		Fair Value
		Gross Unrecognized Gains	Gross Unrecognized Losses	
Agencies	\$ 8,960	\$ 956	\$	\$ 9,916
Corporates				
Mortgage-backed				
Asset-backed				
Treasuries	4,916	102		5,018
Munis	25,945	541		26,486
Total Fixed Income	\$ 39,821	\$ 1,599	\$	\$ 41,420

*Held-to-maturity securities are carried on the condensed consolidated balance sheets at amortized cost and changes in the fair value of these securities, other than impairment charges, are not reported on the financial statements.

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The following table presents the carrying value and fair value of debt securities held-to-maturity by contractual maturity dates as of September 30, 2009 and December 31, 2008:

(in thousands)	9/30/2009		12/31/2008	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Agencies				
Due within 1 year	\$	\$	\$ 1,000	\$ 1,003
After 1 but within 5 years	17,991	18,811	7,960	8,913
After 5 but within 10 years	99,972	100,130		
After 10 years*	44,676	44,327		
Total	162,639	163,268	8,960	9,916
Corporates				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years				
Total				
Mortgage-backed				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years*				
Total				
Asset-backed				
Due within 1 year	\$	\$	\$	\$
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years*				
Total				
Treasuries				
Due within 1 year	\$	\$	\$ 4,916	\$ 5,018
After 1 but within 5 years				
After 5 but within 10 years				
After 10 years*				
Total			4,916	5,018
Munis				
Due within 1 year	\$ 4,999	\$ 5,022	\$ 6,198	\$ 6,239
After 1 but within 5 years	8,949	9,238	17,359	17,713
After 5 but within 10 years	2,144	2,291	2,388	2,534
After 10 years*				
Total	16,092	16,551	25,945	26,486
TOTAL	\$ 178,731	\$ 179,819	\$ 39,821	\$ 41,420

*Investments with no stated maturities are included as contractual maturities of greater than 10 years. Actual maturities may differ due to call or prepayment rights.

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The following table shows the composition of the fixed income securities in unrealized loss positions at September 30, 2009 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)			Percent to Total
			Book Value	Fair Value	Unrealized Loss	
1	AAA/AA/A	Aaa/Aa/A	\$ 136,359	\$ 134,085	\$ (2,274)	75.8%
2	BBB	Baa	16,438	15,860	(578)	19.3%
3	BB	Ba	3,996	3,850	(146)	4.9%
4	B	B				
5	CCC or lower	Caa or lower				
6						
		Total	\$ 156,793	\$ 153,795	\$ (2,998)	100.0%

The fixed income securities rated NAIC 3 are Wm. Wrigley Jr. Co. bonds that mature in 2015. In October 2008, Mars, Inc. completed its acquisition of Wrigley. Subsequently, these bonds are no longer rated by the major rating agencies. These securities continue to pay the expected coupon payments under the contractual terms of the securities.

The fixed income portfolio contained 51 unrealized loss positions as of September 30, 2009. The \$3.0 million in associated unrealized losses for these 51 securities represents 0.2% of the fixed income portfolio's cost basis. Of these 51 securities, 25 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent \$2.0 million in unrealized losses. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. As of April 1, 2009, we adopted recent GAAP guidance on the recognition and presentation of OTTI. Accordingly, 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 a high credit quality and we believe we will recover our amortized cost basis of our fixed income securities. The fixed income unrealized losses can primarily be attributed to changes in interest rates. We continually monitor the credit quality of our fixed income investments to gauge the likelihood of principal and interest being collected.

Through September 30, 2009, the total impairment charge for fixed income securities was \$4.5 million. These securities were other-than-temporarily impaired and either sold or impaired as a result of our intent to sell the securities. Our intent to sell these securities was based on our policy to make decisions to sell on a security by security basis and in this case reflected our belief that other investment opportunities would help us better achieve our investment objectives. Because we have sold or have the intent to sell these securities, the entire amount of the loss was included in net earnings. These securities were deemed other-than-temporarily impairment during the first six months of the year. No additional OTTI charges were incurred in the third quarter of 2009.

Evaluating Investments for Other-than-Temporary Impairments

We conduct periodic reviews to identify and evaluate each investment that has an unrealized loss. An unrealized loss exists when the current fair value of a security is less than its amortized cost. Regardless of the classification of securities as available-for-sale or held-to-maturity, we assess each position for impairment.

Factors that we consider in the evaluation of credit quality include:

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

As of September 30, 2009, we held 11 common stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled \$1.8 million. Of the 11 common stock positions that were in an unrealized loss position, two have been in an unrealized loss position for more than 12 consecutive months. These securities represent \$0.4 million in unrealized losses. Based on our analysis, these securities have the potential for recovery in a reasonable period of time and we have the ability to hold these securities until recovery.

As part of our evaluation of the securities in an unrealized loss position and the potential for recovery in a reasonable period of time, we specifically review equity securities with unrealized losses as to the financial condition and future prospects of the issuers and the price volatility of the equity securities themselves. Securities for which we have the ability and intent to hold at least until the investment impairment is recovered given the future prospects of the issuers, and securities with any unrealized losses due primarily to temporary market and/or sector-related factors other than issuer specific factors, are generally not considered other-than-temporarily impaired.

Through September 30, 2009, the total impairment charge for equity securities was \$40.7 million. These securities were other-than-temporarily impaired and either sold or impaired as a result of our intent to sell the securities. This determination was based on the extent and duration of the market decline and our belief that other securities may offer better opportunities to achieve our investment objectives. As such, we no longer had the intent to hold these securities until recovery and deemed them as other-than-temporarily impaired. These securities were deemed other-than-temporarily impairment during the first six months of the year. No additional OTTI charges were incurred in the third quarter of 2009.

3. FAIR VALUE MEASUREMENTS

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

We determined the fair values of certain financial instruments based on the fair value hierarchy. 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.

Level 1: quoted price (unadjusted) in active markets for identical assets

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument

Level 3: inputs to the valuation methodology are unobservable for the asset or liability

To measure fair value, we obtain quoted market prices based on observable inputs for our investment securities. If a quoted market price is not available, we use quoted market prices based on observable inputs of similar securities.

Assets measured at fair value on a recurring basis are summarized below:

(\$ in 000s) Description	As of September 30, 2009			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
Trading securities	\$	\$	\$	\$ 1,068
Available-for-sale securities	238,590	1,295,233		1,533,823
Total	\$ 238,590	\$ 1,296,301	\$	\$ 1,534,891

As noted in the above table, we do not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period.

4. STOCK BASED COMPENSATION

During 2005, our shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). The purpose of the omnibus plan is to promote our interests and those of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a

high level of corporate performance and to encourage our continued success and growth. Awards under the omnibus plan may be in the form of restricted stock, stock options (both incentive and nonqualified), stock appreciation rights, performance units, as well as other stock based awards. Eligibility under the omnibus plan is limited to our employees or employees of any affiliate and to individuals or entities who are not employees but who provide services to us or an affiliate, including services provided in the capacity of consultant, advisor or director. The granting of awards under the plan is solely at the discretion of the executive resources committee and the board of directors. The total number of shares of common stock available for distribution under the omnibus plan may not exceed 1,500,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we have granted 1,193,000 stock options under this plan, including 244,900 thus far in 2009. Under the omnibus plan, we grant stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant.

Options generally vest and become exercisable ratably over a five-year period. Beginning with the annual grant in May 2009, options granted have an eight-year life. Prior to the May grant, options were granted with a ten-year life. The related compensation expense is recognized over the requisite service period. In most instances, the requisite service period and vesting period will be the same. For participants who are retirement eligible, defined by the plan as those individuals whose age and years of service equals 75, the requisite service period is deemed to be met and options are immediately expensed on the date of grant. For participants who will become retirement eligible during the vesting period, the requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.

The following tables summarize option activity for the periods ended September 30, 2009 and 2008:

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2009	1,429,128	\$ 43.35		
Options granted	244,900	\$ 47.84		
Options exercised	(58,815)	\$ 28.94		\$ 1,403
Options canceled/forfeited	(20,030)	\$ 51.96		
Outstanding options at September 30, 2009	1,595,183	\$ 44.46	6.17	\$ 13,271
Exercisable options at September 30, 2009	923,252	\$ 39.76	4.94	\$ 12,022

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	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2008	1,605,252	\$ 36.34		
Options granted	246,250	\$ 50.52		
Options exercised	(315,351)	\$ 21.90		\$ 12,332
Options canceled/forfeited	(3,120)	\$ 51.42		
Outstanding options at September 30, 2008	1,533,031	\$ 41.56	6.46	\$ 34,279
Exercisable options at September 30, 2008	972,920	\$ 35.30	5.08	\$ 27,845

The majority of our options are granted annually at our regular board meeting in May. Thus far in 2009, 244,900 options were granted with an average exercise price of \$47.84 and an average fair value of \$11.28. We recognized \$0.8 million of expense in the third quarter of 2009, and \$2.1 million in the first nine months of 2009, related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.3 million in the third quarter of 2009, and \$0.8 million in the first nine months of 2009, related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.7 million, which will be recognized over the remainder of the vesting period.

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:

	2009	2008
Weighted-average fair value of grants	\$ 11.28	\$ 12.58
Risk-free interest rates	2.06%	3.29%
Dividend yield	1.56%	1.53%
Expected volatility	26.20%	23.76%
Expected option life	5.71 years	6.34 years

The risk-free rate is determined based on U.S. treasury yields that most closely approximate the option's expected life. The dividend yield is calculated based on the average annualized dividends paid during the most recent five-year period. The expected volatility is calculated based on the mean reversion of RLI's stock. In previous years, it was calculated by computing the weighted average of the most recent one-year volatility, the most recent volatility based on expected life and the median of the rolling volatilities based on the expected life of RLI stock. The expected option life is 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.

5. 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.

SEGMENT DATA (in thousands)

	For the Three-Month Periods Ended September 30, REVENUES				For the Nine-Month Periods Ended September 30, REVENUES				
	2009		2008		2009		2008		
Casualty	\$	64,794	\$	76,993	\$	202,766	\$	237,559	
Property		39,829		36,376		115,394		110,869	
Surety		18,113		17,481		52,750		50,682	
Net premiums earned	\$	122,736	\$	130,850	\$	370,910	\$	399,110	
Net investment income		16,295		19,844		50,494		58,707	
Net realized gains (losses)		6,985		(24,212)		(20,789)		(12,396)	
Total consolidated revenue	\$	146,016	\$	126,482	\$	400,615	\$	445,421	
		NET EARNINGS				NET EARNINGS			
		2009		2008		2009		2008	
Casualty	\$	17,330	\$	18,537	\$	37,380	\$	33,446	
Property		3,914		(11,059)		19,271		10,850	
Surety		1,708		7,719		6,571		14,704	
Net Underwriting Income	\$	22,952	\$	15,197	\$	63,222	\$	59,000	
Net investment income		16,295		19,844		50,494		58,707	
Net realized gains (losses)		6,985		(24,212)		(20,789)		(12,396)	
General corporate expense and interest on debt		(3,689)		(3,381)		(10,384)		(10,950)	
Equity in earnings of unconsolidated investee		1,120		248		5,242		6,417	
Total earnings before income taxes	\$	43,663	\$	7,696	\$	87,785	\$	100,778	
Income tax expense (benefit)		12,644		(890)		24,502		28,083	
Total net earnings	\$	31,019	\$	8,586	\$	63,283	\$	72,695	

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The following table further summarizes revenues (net premiums earned) by major product type within each operating segment:

(in thousands)	For the Three-Month Periods Ended September 30,		For the Nine-Month Periods Ended September 30,	
	2009	2008	2009	2008
Casualty				
General liability	\$ 28,533	\$ 34,163	\$ 88,353	\$ 107,465
Commercial and personal umbrella	15,474	16,335	47,131	48,771
Commercial transportation	10,264	11,292	31,732	35,409
Specialty programs	4,533	8,084	17,217	23,580
Executive coverages	3,956	3,504	11,433	10,057
Other	2,034	3,615	6,900	12,277
Total	\$ 64,794	\$ 76,993	\$ 202,766	\$ 237,559
Property				
Commercial property	\$ 20,915	\$ 19,967	\$ 61,482	\$ 65,710
Marine	12,880	12,928	39,101	35,468
Other property	6,034	3,481	14,811	9,691
Total	\$ 39,829	\$ 36,376	\$ 115,394	\$ 110,869
Surety	\$ 18,113	\$ 17,481	\$ 52,750	\$ 50,682
Grand Total	\$ 122,736	\$ 130,850	\$ 370,910	\$ 399,110

A detailed discussion of earnings and results by segment is contained in management's discussion and analysis of financial condition and results of operations.

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, 2008.

OVERVIEW

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, our principal subsidiary, writes multiple lines insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company, a subsidiary of RLI Insurance Company, writes surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company, a subsidiary of Mt.

Hawley Insurance Company, has authority to write multiple lines of insurance on an admitted basis in 49 states and the District of Columbia. We are an Illinois corporation that was organized in 1965. We have no material foreign operations.

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

The foundation of our overall business strategy is to underwrite for profit in all marketplaces. This drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio, and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly rated, investment grade securities to protect invested assets. Regular 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). Private equity investments, primarily our minority ownership in Maui Jim, Inc. (Maui Jim), have also enhanced overall returns. We have a diversified investment portfolio and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite fluctuations of realized and unrealized gains and losses in the equity portfolio, our investment in equity securities as part of a long-term asset allocation strategy has contributed significantly to our historic growth in book value.

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

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, commercial umbrella, multi-peril program business, and other specialty coverages. In addition, we provide employers' indemnity and in-home business owners coverage. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty segment may also 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 primarily underwrites commercial fire, earthquake, difference in conditions, marine, facultative reinsurance, and in the state of Hawaii, select personal lines policies. Property insurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by limiting the total policy limits written in a particular region, by purchasing reinsurance, and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

The surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. We offer miscellaneous bonds, including license and permit, notary, and court bonds. We also offer fidelity and crime coverage for commercial insureds and select financial institutions. Often, our surety coverages involve a statutory requirement for bonds. While these bonds have maintained a relatively low loss ratio, losses may fluctuate due to adverse economic conditions that may affect the financial viability of an insured. The contract surety marketplace guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic conditions or the deterioration of a contractor's financial condition. As such, this line has historically produced marginally higher loss ratios than other surety lines.

The insurance marketplace softened over the last several years, meaning that the marketplace became more competitive and prices were falling even as coverage terms became less restrictive. Nevertheless, we believe that our business model is geared to create underwriting income by focusing on sound underwriting discipline. Our primary focus will continue to be on underwriting profitability as opposed to premium growth or market share measurements.

GAAP and non-GAAP Financial Performance Metrics

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

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

Underwriting Income

Underwriting income or profit represents one measure of the pretax profitability of our insurance operations and is derived by subtracting losses and settlement expenses, policy acquisition costs, and insurance operating expenses from net premium earned. Each of these captions is presented in the statements of earnings but not subtotaled. However, this information is available in total and by segment in note 5 to the unaudited condensed consolidated financial statements, Operating Segment Information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains/losses on investments, general corporate expenses, debt costs, and unconsolidated investee earnings.

Gross premiums written

While net premiums earned is the related GAAP measure used in the statements of earnings, gross premiums written is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in our insurance underwriting operations with some indication of profit potential subject to the levels of our retentions, expenses and loss costs.

Net premiums written

While net premiums earned is the related GAAP measure used in the statements of earnings, net premiums written is the component of net premiums earned that measures the difference between gross premiums written and the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of

retained or net business volume in our insurance underwriting operations. It provides some indication of profit potential subject to our expenses and loss costs.

Combined ratios

This ratio is a common industry measure of profitability for any underwriting operation, and is calculated in two components. First, the loss ratio is losses and settlement expenses divided by net premiums earned. The second component, the expense ratio, reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. 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 referred to in our disclosures regarding the process of establishing these various estimated amounts.

Critical Accounting Policies

In preparing the condensed consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the 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.

Losses and Settlement Expenses

Overview

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Loss and loss adjustment expense (LAE) reserves represent our best estimate of ultimate amounts for losses and related settlement expenses from claims that have been reported but not paid, and those losses that have occurred but have not yet been reported to us. Loss reserves do not represent an exact calculation of liability, but instead represent our estimates, generally utilizing individual claim estimates and actuarial expertise and estimation techniques at a given accounting date. The loss reserve estimates are expectations of what ultimate settlement and administration of claims will

cost upon final resolution. These estimates are based on facts and circumstances then known to us, review of historical settlement patterns, estimates of trends in claims frequency and severity, projections of loss costs, expected interpretations of legal theories of liability, and many other factors. In establishing reserves, we also take into account estimated recoveries, reinsurance, salvage, and subrogation. The reserves are reviewed regularly by a team of actuaries we employ.

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

Due to inherent uncertainty underlying loss reserve estimates, including but not limited to the future settlement environment, final resolution of the estimated liability may be different from that anticipated at the reporting date. Therefore, actual paid losses in the future may yield a materially different amount than currently reserved – favorable and unfavorable. The amount by which estimated losses differ from those originally reported for a period is known as development. Development is unfavorable when the losses ultimately settle for more than the levels at which they were reserved or subsequent estimates indicate a basis for reserve increases on unresolved claims. Development is favorable when losses ultimately settle for less than the amount reserved or subsequent estimates indicate a basis for reducing loss reserves on unresolved claims. We reflect favorable or unfavorable developments of loss reserves in the results of operations in the period the estimates are changed.

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

Within a reasonable period of time after a claim is reported, our claim department completes an initial investigation and establishes a case reserve. This case-specific reserve is an estimate of the ultimate amount we will have to pay for the claim, including related legal expenses and other costs associated with resolving and settling a particular claim. The estimate reflects all of the current information available regarding the claim, the informed judgment of our professional claim personnel, our reserving practices and experience, and the knowledge of such personnel regarding the nature and value of the specific type of claim. During the life cycle of a particular claim, more information may materialize that causes us to revise the estimate of the ultimate value of the claim either upward or downward. We may determine

that it is appropriate to pay portions of the reserve to the claimant or related settlement expenses before final resolution of the claim. The amount of the individual claim reserve will be adjusted accordingly and is based on the most recent information available.

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

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

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

All decisions regarding our best estimate of ultimate loss and LAE reserves are made by our Loss Reserve Committee (LRC). The LRC is made up of various members of the management team including the chief executive officer, chief operating officer, chief financial officer, chief actuary, general counsel and other selected executives. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses. Based on current assumptions used in calculating reserves, we believe that our overall reserve levels at September 30, 2009, make a reasonable provision to meet our future obligations.

Initial IBNR Generation Process

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

For most property products, we use an alternative method of determining an appropriate provision for initial IBNR. Since this segment is characterized by a shorter period of time between claim occurrence and claim settlement, the IBNR reserve is determined by an initial loss percentage applied to the rolling 12 month s premium earned. No deductions for paid or case reserves are made. This alternative method of determining initial IBNR reacts more quickly to the actual loss emergence and is more appropriate for our property products where final claim resolution occurs quickly.

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

The initial loss and ALAE ratios that are applied to earned premium are reviewed at least semi-annually. Prospective estimates are made based on historical loss experience adjusted for mix and price change and loss cost inflation. The initial loss and ALAE ratios also reflect some provision for estimation risk. We consider estimation risk by segment and product line. A segment with greater overall volatility and uncertainty has greater estimation risk. Characteristics of segments and products with higher estimation risk, include those exhibiting, but not limited to, the following characteristics:

- significant changes in underlying policy terms and conditions,
- a new business or one experiencing significant growth and/or high turnover,
- small volume or lacking internal data requiring significant reliance on external data,
- longer emergence patterns with exposures to latent unforeseen mass tort,
- high severity and/or low frequency,
- operational processes undergoing significant change, and/or
- high sensitivity to significant swings in loss trends or economic change.

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

Loss and LAE Reserve Estimation Process

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

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

In addition to the review of historical claim reporting and payment patterns, we also incorporate an estimate of expected losses relative to premium by year into the analysis. The expected losses are based on a review of historical loss performance, trends in frequency and severity, and price level changes. The estimation of expected losses is subject to judgment including consideration given to internal and industry data available, growth and policy turnover, changes in policy limits, changes in underlying policy provisions, changes in legal and regulatory interpretations of policy provisions, and changes in reinsurance structure.

We use historical development patterns, estimations of the expected loss ratios, and standard actuarial methods to derive an estimate of the ultimate level of loss and LAE payments necessary to settle all the claims occurring as of the end of the evaluation period. Once an estimate of the ultimate level of claim payments has been derived, the amount of paid loss and LAE and case reserve through the evaluation date is subtracted to reveal the resulting level of IBNR.

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

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

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

- loss payment patterns,
- loss reporting patterns,
- frequency and severity trends,
- underlying policy terms and conditions,
- business or exposure mix,
- operational or internal process changes affecting timing of recording transactions,
- regulatory and legal environment, and/or
- economic environment.

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

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

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

Determination of Our Best Estimate

Upon completion of our full loss and LAE estimation analysis, the results are discussed with the LRC. As part of this discussion, the analysis supporting an indicated point estimate of the IBNR loss reserve by product is reviewed. The actuaries also present explanations supporting any changes to the underlying assumptions used to calculate the indicated point estimate. Quarterly, we also consider the actual loss emergence as compared to the expected loss emergence derived from the last full loss and LAE analyses. A review of the resulting variance between the indicated reserves and the carried reserves determined from the initial IBNR generation process takes place. After discussion of these analyses and all relevant risk factors, the LRC determines whether the reserve balances require adjustment.

As a predominantly excess and surplus lines and specialty insurer servicing niche markets, we believe there are several reasons to carry on an overall basis reserves above the actuarial point estimate. We believe we are subject

to above-average variation in estimates and that this variation is not symmetrical around the actuarial point estimate.

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

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

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

Our best estimate of our loss and LAE reserves may change depending on a revision in the actuarial point estimate, the actuary's certainty in the estimates and processes, and our overall view of the underlying risks. From time to time, we benchmark our reserving policies and procedures and refine them by adopting industry best practices where appropriate. A detailed, ground-up analysis of the actuarial estimation risks associated with each of our products and segments, including an assessment of industry information, is performed annually.

Loss reserve estimates are subject to a high degree of variability due to the inherent uncertainty of ultimate settlement values. Periodic adjustments to these estimates will likely occur as the actual loss emergence reveals itself over time. We believe our loss reserving processes reflect industry best practices and our methodologies result in a reasonable provision for reserves as of September 30, 2009.

Investment Valuation and Other-Than-Temporary Impairment

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

We classify our investments in debt and equity securities with readily determinable fair values into one of three categories. Held-to-maturity securities are carried at amortized cost. Available-for-sale securities are carried at fair value with unrealized gains/losses recorded as a component of comprehensive earnings and shareholders' equity, net of deferred income taxes. Trading securities are carried at fair value with unrealized gains/losses included in earnings.

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

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

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

Factors that we consider in the evaluation of credit quality include:

- changes in technology that may impair the earnings potential of the investment,

- the discontinuance of a segment of the business that may affect the future earnings potential,
- reduction or elimination of dividends,
- specific concerns related to the issuer's industry or geographic area of operation,
- significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
- downgrade in credit quality by a major rating agency.

For mortgage-backed securities and asset-backed securities that have significant unrealized loss positions and major rating agency downgrades, credit impairment is assessed using a cash flow model that estimates likely payments using security-specific collateral and transaction structure. All our mortgage-backed and asset-backed securities remain AAA rated by the major rating agencies and the fair value is not significantly less than amortized cost. In addition, the current cash flow assumptions are the same assumptions used at purchase which reflects no current credit issues at this time.

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

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

Recoverability of Reinsurance Balances

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, rather than being netted with the related liabilities, since reinsurance does not relieve us of our liability to policyholders. Such balances are subject to the credit risk associated with the individual reinsurer. Additionally, the same uncertainties associated with estimating unpaid losses and settlement expenses impact the estimates for the ceded portion of such liabilities.

We continually monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements, Securities and Exchange Commission filings, A.M. Best and S&P rating developments, and insurance industry developments that may impact the financial condition of our reinsurers. In addition, we subject our reinsurance recoverables to detailed recoverable tests, including one based on average default by S&P rating. Based upon our review and testing, our policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that we may be unable to recover. Further discussion of our reinsurance balances recoverable can be found in note 5 to the financial statements included in our 2008 Annual Report on Form 10-K.

Deferred Policy Acquisition Costs

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

Deferred Taxes

We record net deferred tax assets to the extent temporary differences representing future deductible items exceed future taxable items. A significant amount of our deferred tax assets relate to expected future tax deductions arising from claim reserves and future tax deductions related to changes in our investments unrealized gain or loss positions.

Since there is no absolute assurance that these assets will be ultimately realized, management reviews our deferred tax positions to determine if it is more-likely-than-not that the assets will be realized. Periodic reviews include, among other things, the nature and amount of the taxable income and expense items, the expected timing of when assets will be used or liabilities will be required to be reported and the reliability of historical profitability of businesses expected to provide future earnings. Furthermore, management considers tax-planning strategies it can use to increase the likelihood that the tax assets will be realized. If after conducting the periodic review, management determines that the realization of the tax asset does not meet the more-likely-than-not criteria, an offsetting valuation allowance is recorded, thereby reducing net earnings and the deferred tax asset in that period. In addition, management must make estimates of the tax rates expected to apply in the periods in which future taxable items are realized. Such estimates include determinations and judgments as to the expected manner in which certain temporary differences, including deferred

amounts related to our equity method investment, will be recovered and thereby the applicable tax rates. These estimates are subject to change based on the circumstances.

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

NINE MONTHS ENDED SEPTEMBER 30, 2009, COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2008

Consolidated revenues, as displayed in the table that follows, totaled \$400.6 million for the first nine months of 2009 compared to \$445.4 million for the same period in 2008.

	For the Nine-Month Period Ended September 30,	
	2009	2008
Consolidated revenues (in thousands)		
Net premiums earned	\$ 370,910	\$ 399,110
Net investment income	50,494	58,707
Net realized investment losses	(20,789)	(12,396)
Total consolidated revenue	\$ 400,615	\$ 445,421

Consolidated revenue for the first nine months of 2009 decreased \$44.8 million, or 10%, from the same period in 2008. Net premiums earned for the Group decreased 7% from 2008 levels, as casualty writings continue to decline due to overall rate softening. Net investment income declined 14% to \$50.5 million due to changes in asset allocation and a lower interest rate environment. Investment losses for both periods were the result of unease in the financial system and overall market volatility experienced, particularly during the last half of 2008 and first quarter of 2009, which is discussed in further detail below.

Net after-tax earnings for the first nine months of 2009 totaled \$63.3 million, \$2.91 per diluted share, compared to \$72.7 million, \$3.32 per diluted share for the same period in 2008. While both periods benefited from positive underwriting income that was bolstered by favorable reserve development, results for 2009 were negatively impacted by lower investment income and net realized investment losses. In 2009, favorable development on prior years' loss and hurricane reserves resulted in additional pretax earnings of \$45.2 million. In 2008, favorable development on prior years' loss reserves resulted in additional pretax earnings of \$42.8 million. Partially offsetting this favorable development in 2008 was \$24.0 million in pre-tax hurricane losses. Bonus and profit sharing-related expenses related to these specific items totaled \$7.2 million in 2009 and \$0.3 million in 2008. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital).

During the first nine months of 2009, equity in earnings of unconsolidated investee totaled \$5.2 million from Maui Jim, Inc. (Maui Jim). The first nine months of 2008 reflected \$6.4 million in Maui Jim income. Maui Jim, a producer of premium sunglasses, has been affected by the slowdown in economic conditions and the ensuing effect on consumer discretionary spending. During 2009, Maui Jim has recorded foreign exchange gains on accounts receivable from international sunglass sales, which has served to partially offset the impact of the economic slowdown. During 2008, Maui Jim recorded foreign exchange losses on these receivables, which negatively impacted earnings. The decreasing value of the dollar during 2009 resulted in currency gains, while the increasing value of the dollar in 2008 resulted in currency losses.

Results for the first nine months of 2009 included pretax net realized losses of \$20.8 million, compared to pretax net realized losses of \$12.4 million, for the same period last year. The majority of our realized losses relate to impairments of equity securities as well as a position in a market related exchange traded fund which was liquidated, both in the first half of the year. Of the total net realized losses, \$45.2 million represents impairment losses through September 30, 2009. Results for 2008 were also impacted by \$37.7 million of impairment losses. The majority of 2008 losses were incurred during the third quarter and were related to the turmoil experienced in the financial sector.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (loss) (primarily the change in unrealized gains/losses net of tax), totaled \$126.6 million, \$5.82 per diluted share, for the first nine months of 2009, compared to comprehensive earnings of \$4.4 million, \$0.20 per diluted share, for the same period in 2008. Unrealized gains, net of tax, for the first nine months of 2009 were \$63.4 million, compared to unrealized losses of \$68.3 million for the same period in 2008. Both the bond and equity markets rallied during the second and third quarter of 2009, while the financial crisis in 2008 negatively impacted both markets. In addition, current asset allocation strategies have focused on limiting the impact of volatility in the equity markets, while placing a higher portfolio allocation to short-term investments.

RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group declined to \$487.2 million for the first nine months of 2009 from \$518.9 million for the same period of 2008, as the continued decline in casualty writings served to offset growth in writings from property and surety. Underwriting income for the Group increased to \$63.2 million for the first nine months of 2009. Underwriting income for 2009 benefited from \$45.2 million in favorable development on prior accident years' loss and hurricane reserves, as well as a benign hurricane season. In 2008, underwriting income included \$42.8 million in favorable development on prior accident years' loss reserves, which was partially offset by \$24.0 million in losses from hurricanes. The GAAP combined ratio totaled 82.9 in 2009, compared to 85.2 in 2008. While overall underwriting results have improved in 2009, current accident year results have been negatively impacted by the decline in premiums. Rate reductions have the effect of increasing loss ratio assumptions and acquisition expenses, as a percentage of premiums earned increase, particularly on casualty products, which are discussed further below.

Overall, the combined ratio for the casualty segment was 81.6 for 2009 compared to 85.9 in 2008. The segment's loss ratio was 47.7 in 2009 compared to 54.8 in 2008, primarily driven by the higher amount of aforementioned favorable development in 2009 on prior accident years. As described in our 2008 Annual Report on Form 10-K, we reflect historical loss experience, historical and projected price changes, and historical and projected loss cost inflation in our expected loss ratio projections. For 2009, we anticipated continued rate declines. While favorable loss trends have partially mitigated the impact, the continued decline in rate has resulted in increased loss ratio estimates for the 2009 accident year. The expense ratio for the casualty segment was 33.9 for the first nine months of 2009 compared to 31.1 for the same period of 2008. The decline in premium during 2009 has resulted in reduced leverage on acquisition-related expenses.

Property

Gross premiums written for the Group's property segment totaled \$164.0 million for the first nine months of 2009, an increase of \$12.6 million, or 8%, from the same period last year. Our domestic fire book recorded gross premiums written of \$59.0 million, an increase of \$3.7 million, or 7%, from the same period last year. Difference-in-conditions (DIC) gross premiums written increased \$3.1 million, or 8%, to \$39.5 million for the first nine months of 2009. We have experienced rate increases in both of these lines and have been able to increase premium while reducing overall exposures. After posting a 7% increase in premium during the first half of 2009, our marine product posted a decline in premium during the third quarter. Through September, marine recorded \$46.6 million in gross premiums written, slightly below last year's amount. The exit of the commercial tug and tow business, which began in April 2009, has resulted in reduced premium writings. Our facultative reinsurance product, launched in 2007, grew \$6.8 million, or 258%, to \$9.4 million in gross premiums written for the first nine months of 2009.

Underwriting income for the segment was \$19.3 million for the first nine months of 2009, compared to \$10.9 million for the same period in 2008. Results for 2009 reflect a low loss ratio on our commercial fire book coupled with a benign hurricane season. Partially offsetting these factors, however, was unfavorable loss experience on current and prior accident years for marine. This development is primarily attributable to the commercial tug and towing class of business that impacts both hull and protection and indemnity coverages. Underwriting action, including the non-renewal of unprofitable accounts, was initiated in late 2008 and has continued in 2009. As a direct result of poor underwriting results in this marine class, we increased IBNR reserves on current and prior accident years for the affected coverages. These additions negatively impacted the segment's underwriting results by \$10.2 million. On a positive note, reserves for the 2008 hurricanes and run-off construction business continued to trend favorably. During 2009, we experienced \$2.7 million of favorable development on 2008 hurricane reserves and \$0.8 million of other favorable development, primarily on construction reserves. From a comparative standpoint, results for 2008 included \$22.5 million in losses associated with Hurricanes Gustav and Ike.

Segment results for 2009 translate into a combined ratio of 83.3, compared to 90.2 for the same period last year. The segment's loss ratio was 43.1 in 2009 compared to 51.2 in 2008, which was impacted by hurricane losses. From an expense standpoint, the segment's expense ratio, which was impacted by increased bonus and profit sharing expenses was 40.2 for 2009, compared to 39.0 for 2008.

Surety

The surety segment recorded gross premiums written of \$68.3 million for the first nine months of 2009, an increase of \$8.6 million, or 14%, from the same period last year. Premium growth was experienced across fidelity, contract and miscellaneous lines, while commercial and energy writings declined slightly. Our fidelity division, which launched in September 2008, added gross premiums written of \$7.9 million in the first nine months of 2009. The segment recorded underwriting income of \$6.6 million, compared to \$14.7 million for the same period last year. Results for 2008 include favorable loss development on prior accident years, primarily 2007, which improved the segment's underwriting results by \$6.0 million.

The combined ratio for the surety segment totaled 87.5 in 2009, versus 71.0 for the same period in 2008. The segment's loss ratio was 21.2 for 2009, compared to 6.0 for 2008, due to the aforementioned favorable development in 2008 on prior accident years. The expense ratio for 2009 was 66.3 compared to 65.0 for the same period last year, reflective of increased expenses associated with product expansion.

INVESTMENT INCOME AND REALIZED CAPITAL GAINS

During the second and third quarters, the capital markets have continued to improve after a volatile first quarter. The significant rally in both the fixed income and equity markets has greatly reduced the number of securities with and the amount of unrealized losses. In addition, our analysis concludes that none of the current positions with an unrealized loss are OTTI.

While both the fixed income and equity markets have rallied substantially over the past six months, some market indicators remain weak. As such, and as evidenced in our investment allocation table below, we have continued to underweight our equity exposures in an attempt to reduce the volatility of our portfolio.

(in thousands)	9/30/2009		12/31/2008	
	Financial Stmt Value	%	Financial Stmt Value	%
Fixed income	1,475,032	79.5%	1,274,056	76.8%
Equity securities	238,590	12.8%	286,790	17.3%
Short-term investments	142,771	7.7%	97,982	5.9%
Total	1,856,393	100.0%	1,658,828	100.0%

In the first half of 2009, we eliminated all our positions in preferred stocks, real estate investment trusts (REITs), and our high yield municipal bond mutual fund. Our current equity allocation represents 13% of our total investment portfolio.

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We believe our 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.

During the first nine months of 2009, net investment income decreased by 14.0% over that reported for the same period in 2008. The decrease in investment income is a result of our eliminating higher yielding equity securities including preferred stock, the high-yield municipal bond fund, and REITs. These securities were deemed other-than-temporarily impaired during the second half of 2008 and ultimately disposed of during 2009. Through the first nine months of 2009, we continue to hold a higher than usual allocation to short-term investments yielding substantially less than the more volatile equity securities previously held. In addition, short-term rates have substantially declined as a result of the Federal Reserve cutting short-term rates to near 0%.

The average annual yields on our fixed income investments (excluding short-term investments) for the first nine months of 2009 and 2008 were as follows:

	2009	2008
<u>Pretax Yield</u>		
Taxable	5.12%	5.47%
Tax-Exempt	3.94%	4.01%
<u>After-tax yield</u>		
Taxable	3.33%	3.56%
Tax-Exempt	3.73%	3.80%

The fixed income portfolio increased by \$201.0 million in the first nine months of 2009. This portfolio had a tax-adjusted total return on a mark-to-market basis of 8.4%. The equity portfolio had a total return of 10.2% for the first three quarters of 2009. Our equity portfolio declined by \$48.2 million during the first nine months, to \$238.6 million.

We continuously monitor the values of our investments in fixed income securities and equity securities for OTTI. If this review suggests that a decline in fair value is other-than-temporary based upon many factors including the duration or significance of the unrealized loss, our carrying value in the investment is reduced to its fair value through an adjustment to earnings.

We recognized a total of \$20.8 million in net realized losses in the first nine months of 2009, compared to net realized losses of \$12.4 million in the first nine months of 2008. Of the 2009 total, \$45.2 million of losses relates to OTTI charges that were taken because there were changes in our intent to no longer hold the security or the anticipated recovery period was deemed unreasonable. During the first nine months of 2009, we realized \$7.8 million in gains on securities sold that were previously written down as being other-than-temporarily impaired.

We regularly review investment securities for impairment using both quantitative and qualitative criteria. Quantitative criteria include length of time and amount that each security is in an unrealized loss position and, for fixed maturities, whether the issuer is in compliance with terms and covenants of the security. Qualitative criteria include the financial health

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of and specific prospects for the issuer, as well as our intent to sell or if it is more-likely-than-not that we will be required to sell the fixed income security before recovery of its amortized cost basis or our intent and ability to hold the equity security for a reasonable period of time until recovery.

In the first three quarters of 2008, there were \$37.7 million in losses associated with impaired securities.

The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity stock portfolio as of September 30, 2009, including fair value, cost basis, and unrealized gains and losses.

	Cost Basis	Fair Value	9/30/2009 Unrealized		Net	Unrealized Gain/Loss % (1)
			Gains	Losses		
(dollars in thousands)						
Consumer Discretionary	\$ 13,425	\$ 14,258	\$ 1,409	\$ (576)	\$ 833	6.2%
Consumer Staples	12,974	25,142	12,168		12,168	93.8%
Energy	11,119	21,995	10,991	(115)	10,876	97.8%
Financials	18,355	25,362	7,055	(48)	7,007	38.2%
Healthcare	6,801	14,605	7,873	(69)	7,804	114.7%
Industrials	16,800	25,116	8,316		8,316	49.5%
Materials	4,053	4,526	473		473	11.7%
Information Technology	15,787	23,731	7,988	(44)	7,944	50.3%
Telecommunications	4,409	8,251	3,842		3,842	87.1%
Utilities	39,662	50,911	12,203	(954)	11,249	28.4%
ETF	23,120	24,693	1,573		1,573	6.8%
	\$ 166,505	\$ 238,590	\$ 73,891	\$ (1,806)	\$ 72,085	43.3%

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

In addition to our equity portfolio shown above, we maintain an allocation to municipal fixed income securities. As of September 30, 2009, we had \$429.9 million in municipal securities. As of September 30, 2009, approximately 16% of our municipal bond portfolio maintains an AAA rating, and 65% of our municipal bond portfolio maintains an AA rating.

INCOME TAXES

Our effective tax rate for the first nine months of 2009 and 2008 was 28%. Effective rates are dependent upon components of pretax earnings and the related tax effects. Both periods reflect similar levels of underwriting income and realized investment losses, which are taxed at 35%. In addition, the proportion of items that are non-taxable or partially-taxed was similar between periods.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the first nine months of 2009 and 2008 as a result of the following:

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(in thousands)	2009		2008	
	Amount	%	Amount	%
Provision for income taxes at the Statutory rate of 35%	\$ 30,725	35%	\$ 35,272	35%
Increase (reduction) in taxes resulting from:				
Tax exempt interest income	(4,036)	-5%	(4,834)	-5%
Dividends received deduction	(1,086)	-1%	(2,499)	-2%
Dividends paid deduction	(420)	0%	(378)	0%
Other items, net	(681)	-1%	522	0%
Total tax expense	\$ 24,502	28%	\$ 28,083	28%

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 changes in debt and shares outstanding.

The following table summarizes cash flows for the nine-month periods ended September 30, 2009 and 2008:

	2009		2008	
	(in thousands)			
Operating cash flows	\$ 108,445	\$	\$ 126,732	\$
Investing cash flows	(101,397)	\$	(39,030)	\$
Financing cash flows	(7,048)	\$	(87,702)	\$
Total	\$	\$	\$	\$

Cash flows from operating activities decreased during the first nine months of 2009 compared to that reported for the same period in 2008, due largely to a decrease in premiums written. In addition, reinsurance receipts are down in 2009. There were several large claims settled in the fourth quarter of 2007 on which reinsurance proceeds were received in early 2008.

We have \$100.0 million in long-term debt outstanding. On December 12, 2003, we completed a public debt offering, issuing \$100.0 million in senior notes maturing January 15, 2014 (a 10-year maturity), and paying interest semi-annually at the rate of 5.95% per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. The estimated fair value for the senior note at September 30, 2009 was \$101.7 million. The fair value of our long-term debt is estimated based on the limited observable prices that reflect thinly traded securities.

We are not party to any off-balance sheet arrangements.

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As of September 30, 2009, we had short-term investments and other investments maturing within one year of approximately \$172.0 million and investments of \$473.2 million maturing within five years. As of September 30, 2009, our short-term investments were held in government funds within multiple fund families, including JPMorgan, Federated, and Fidelity. All funds are NAIC-approved, 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 JPMorgan Chase, which permits us to borrow up to an aggregate principal amount of \$25.0 million. Under certain conditions, the line may be increased up to an aggregate principal amount of \$50.0 million. The facility has a three-year term that expires on May 31, 2011. As of September 30, 2009, no amounts were outstanding on this facility.

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

We have not had any liquidity issues affecting our operations as we have sufficient cash flow to support operations. In addition to the line of credit, our highly liquid investment portfolio and additional reverse repurchase debt capacity provide additional sources of liquidity.

We maintain a well-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, 2009, our investment portfolio had a book value of \$1.9 billion. Invested assets at September 30, 2009, increased by \$197.6 million from December 31, 2008.

As of September 30, 2009, our investment portfolio had the following asset allocation breakdown:

Portfolio Allocation

(in thousands)

Asset Class	Cost or Amortized Cost	Fair Value	Unrealized Gain/(Loss)	% of Total Fair Value	Quality
Agencies	\$ 322,203	\$ 324,234	\$ 2,031	17.4%	AAA
Corporates	381,891	401,131	19,240	21.6%	A
Mortgage-backed	243,145	250,953	7,808	13.5%	AAA
Asset-backed	61,533	62,545	1,012	3.4%	AAA
Treasuries	6,654	6,938	284	0.4%	AAA
Munis	411,632	430,319	18,687	23.2%	AA
Total Fixed Income	\$ 1,427,058	\$ 1,476,120	\$ 49,062	79.5%	AA
Equities	\$ 166,505	\$ 238,590	\$ 72,085	12.8%	
Short-term investments	\$ 142,771	\$ 142,771		7.7%	

Total Portfolio	\$	1,736,334	\$	1,857,481	\$	121,147	100.0%
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Our investment portfolio does not have any exposure to credit default swaps or derivatives. We completely exited our securities lending program as of June 30 this year.

As of September 30, 2009, our fixed income portfolio had the following rating distribution:

AAA	48.6%
AA	22.0%
A	20.7%
BBB	8.3%
NR	0.4%
Total	100.0%

Bonds shown as NR are the previously mentioned Wm. Wrigley Jr. Co. bonds as well as three municipal bonds that have chosen not to renew their ratings.

As of September 30, 2009, the duration of the fixed income portfolio was 5.1 years. Our fixed income portfolio remained well diversified, with 653 individual issues as of September 30, 2009.

Our investment portfolio has limited exposure to structured asset-backed products. We have \$14.6 million in asset-backed securities which are pools of assets collateralized by cash flows from several types of loans, including home equity, credit cards, autos, and similar obligations. The majority of our asset-backed portfolio is comprised of rate reduction utility bonds.

Included in the asset-backed securities total is \$1.8 million in subprime home equity exposure. We have \$48.0 million in securities backed by commercial mortgages and \$251.0 million in securities backed by conforming government-sponsored enterprise (Freddie Mac, Fannie Mae and Ginnie Mae) residential loans. Excluding the conforming Freddie Mac, Fannie Mae, and Ginnie Mae mortgages, our exposure to asset-backed products and commercial mortgage-backed securities is 4% percent of our investment portfolio and our direct subprime exposure is less than one percent.

At September 30, 2009, our equity portfolio had a fair value of \$238.6 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, 2009, our equity portfolio had a dividend yield of 3.0% compared to 2.3% 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 only 14.2% on dividends, compared to 35.0% on taxable interest and 5.3% on municipal bond interest income. As with our bond portfolio, we maintain a well-diversified group of 79 equity securities.

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Our capital structure is comprised of equity and debt outstanding. As of September 30, 2009, our capital structure consisted of \$100.0 million in

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10-year maturity senior notes maturing in 2014 (long-term debt) and \$826.9 million of shareholders' equity. Debt outstanding comprised 12.1% of total capital as of September 30, 2009.

We paid a quarterly cash dividend of \$0.27 per share on October 15, 2009, the same amount as the prior quarter. We have paid dividends for 133 consecutive quarters and increased dividends in each of the last 34 years.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authority of Illinois. The maximum distribution in a rolling 12-month period is limited by Illinois law to the greater of 10% of policyholder surplus as of December 31 of the preceding year or the net income of the Company for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend that can be paid by RLI Insurance Company in a rolling 12-month period ending in 2009 without prior approval is \$67.8 million which represents 10% of RLI Insurance Company's policyholder surplus at December 31, 2008. The total dividend paid in the first nine months of 2009 was \$20.0 million. Other dividends paid in the previous three months totaled \$5.0 million, bringing the total for the rolling 12-month period to \$25.0 million. These dividends are paid to provide additional capital to RLI Corp. from RLI Insurance Company and used for shareholder dividends, interest on senior notes, and general corporate expenses.

Interest and fees on debt obligations totaled \$4.5 million for the first nine months of 2009, down \$0.7 million from the same period in 2008. As of September 30, 2009, outstanding debt balances totaled \$100.0 million, the same amount outstanding at September 30, 2008. Debt balances at September 30, 2009 and September 30, 2008 were comprised of the \$100.0 million in senior notes. We have incurred interest expense on debt at the following average interest rates for the nine-month periods ended September 30, 2009 and 2008:

	2009	2008
Line of Credit	NA	NA
Reverse repurchase agreements	NA	3.41%
Total short-term debt	NA	3.41%
Senior Notes	6.02%	6.02%
Total Debt	6.02%	5.48%

THREE MONTHS ENDED SEPTEMBER 30, 2009 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2008

Consolidated revenues, as displayed in the table that follows, totaled \$146.0 million for the third quarter of 2009 compared to \$126.5 million for the same period in 2008.

	For the Three-Month Period Ended September 30,	
	2009	2008
Consolidated revenues (in thousands)		
Net premiums earned	\$ 122,736	\$ 130,850
Net investment income	16,295	19,844
Net realized investment gains (losses)	6,985	(24,212)
Total consolidated revenue	\$ 146,016	\$ 126,482

Consolidated revenue for the third quarter of 2009 increased \$19.5 million, or 15%, from the same period in 2008, which was negatively impacted by realized losses on the investment portfolio. Net premiums earned for the Group decreased 6% from 2008 levels, as casualty writings continue to decline due to overall rate softening. Net investment income declined 18% to \$16.3 million due to changes in asset allocation and a lower interest rate environment. Net realized investments gains (losses) totaled a gain of \$7.0 million in the third quarter of 2009, compared to losses of \$24.2 million in 2008. The result for 2008 was reflective of realized losses, the majority of which were other-than-temporarily-impaired securities primarily centered within our preferred stock portfolio which was concentrated in the financial sector.

Net after-tax earnings for the third quarter of 2009 totaled \$31.0 million, \$1.42 per diluted share, compared to \$8.6 million, \$0.40 per diluted share, for the same period in 2008. While both periods reflect favorable reserve development on prior accident years, results for 2008 were negatively impacted by hurricane losses and realized investment losses. In the third quarter of 2009, favorable development on prior years' loss and hurricane reserves resulted in additional pretax earnings of \$18.2 million. Bonus and profit sharing-related expenses related to these favorable developments totaled \$3.1 million in 2009. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonuses earned by executives, managers and associates are predominately influenced by corporate performance (operating earnings and return on capital). Comparatively, in the third quarter of 2008, favorable development on prior years' loss reserves resulted in additional pretax earnings of \$24.3 million, which was offset by \$24.0 million in hurricane losses.

During the third quarter of 2009, equity in earnings of unconsolidated investee totaled \$1.1 million from Maui Jim. The third quarter of 2008 reflected \$0.2 million in Maui Jim income, negatively affected by currency losses on accounts receivable from international sunglass sales.

Results for the third quarter of 2009 included pretax net realized gains of \$7.0 million, compared to net realized losses of \$24.2 million, for the same period last year. Results for 2008 were negatively impacted by the financial crisis and corresponding impact on our preferred stock portfolio which was heavily weighted in the financial sector. These securities were exited subsequent to the third quarter of 2008. Realized gains are taxed at the statutory rate of 35%.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses net of tax), totaled \$68.0 million, \$3.12 per diluted share, for the third quarter of 2009, compared to a comprehensive loss of \$15.5 million, \$0.72 per diluted share, for the same period in 2008. Unrealized gains, net of tax, for the third quarter of 2009 were \$37.0 million, compared to unrealized losses, net of tax, of \$24.1 million for the same period in 2008. Results for 2009 reflect the rally in both the bond and equity markets, while results for 2008 were impacted by uncertainty in the economy and financial markets, which caused equity markets to decline.

RLI INSURANCE GROUP

As reflected in the table below, gross premiums written for the Group declined to \$159.9 million for the third quarter of 2009 from \$172.9 million in the third quarter of 2008, as the casualty writings continued to decline. Underwriting income for the Group improved \$7.7 million to \$23.0 million for the third quarter of 2009. Both periods benefited from favorable development on prior accident years' loss reserve releases. Results for 2008, however, were negatively impacted by hurricane losses. The GAAP combined ratio totaled 81.3 in 2009, compared to 88.3 in 2008.

	For the Three-Month Period Ended September 30,	
	2009	2008
Gross premiums written (in thousands)		
Casualty	\$ 83,337	\$ 99,570
Property	51,177	51,599
Surety	25,406	21,728
Total	\$ 159,920	\$ 172,897
Underwriting income (loss) (in thousands)		
Casualty	\$ 17,330	\$ 18,537
Property	3,914	(11,059)
Surety	1,708	7,719
Total	\$ 22,952	\$ 15,197
Combined ratio		
Casualty	73.2	75.9
Property	90.2	130.4
Surety	90.6	55.8
Total	81.3	88.3

Casualty

Gross premiums written for the casualty segment totaled \$83.3 million for the third quarter of 2009, a decrease of \$16.2 million, or 16%, from the same period last year. This segment continues to feel the pressure of rate reductions. General liability, our largest casualty product, recorded gross premiums written of \$25.4 million for the third quarter of 2009, down 22% from the same period last year. As discussed previously, nearly 50% of the general liability book is construction-related. The reduction in construction activity has a direct correlation to gross premium writings as well as loss exposure. Specialty program gross premiums written totaled \$1.9 million for 2009, a decrease of \$7.3 million, or 79%, from the third quarter of 2008. This decrease is reflective of our continued re-underwriting of the book, including exiting certain unprofitable classes of business. Our deductible buy-back program, which was written through an individual producer, declined \$3.8 million from the same period last year as we discontinued the program in late 2008.

In total, the casualty segment recorded underwriting income of \$17.3 million, compared to \$18.5 million for the same period last year. Both periods

included favorable development on prior years' loss reserves. Products affected were primarily general liability, transportation and commercial and personal umbrella. Due to positive emergence, during the third quarter of 2009, we released reserves which improved the segment's underwriting results by \$19.1 million. From a comparative standpoint, results for 2008 included \$18.8 million of favorable loss experience on prior accident years, primarily for general liability and commercial and personal umbrella.

Overall, the combined ratio for the casualty segment was 73.2 for 2009 compared to 75.9 in 2008. The segment's loss ratio was 37.4 in 2009 compared to 44.3 in 2008. While current accident year loss ratio estimates are higher than in 2008, actuarial loss projections for the 2009 accident year were reduced during the third quarter as loss trends have continued to be favorable. The expense ratio for the casualty segment was 35.8 for the third quarter of 2009 compared to 31.6 for the same period of 2008.

Property

Gross premiums written for the Group's property segment totaled \$51.2 million, similar to that reported for the same period last year. Our domestic fire book recorded gross premiums written of \$16.6 million, a decrease of \$0.9 million, or 5%, from the same period last year. While wind rates softened a bit during the third quarter, rates remain above those experienced last year. The decline in premiums is reflective of decreased exposures. Difference-in-conditions (DIC) gross premiums written increased \$0.4 million, or 3%, to \$12.0 million for the third quarter of 2009. Modest rate increases have been achieved, while keeping overall exposures relatively flat. Our facultative reinsurance division, launched in 2007, grew \$2.5 million, or 249%, to \$3.6 million for the third quarter of 2009. After posting a 7% increase in premium during the first half of 2009, our marine division posted a decline in premium during the third quarter. For the third quarter, marine recorded \$15.5 million in gross premiums written, down 13% from the same period last year. This decline was largely due to exiting the commercial tug and tow business, a class of marine business that had experienced adverse loss experience.

The property segment had underwriting income of \$3.9 million for the third quarter of 2009, compared to an underwriting loss of \$11.1 million for the same period in 2008. Results for 2009 reflect a low loss ratio on our commercial fire book coupled with a benign hurricane season. Partially offsetting these factors, however, was unfavorable loss experience on current and prior accident years for our marine division. This development is primarily attributable to the commercial tug and towing class of business that impacts both hull and protection and indemnity coverages. Underwriting action, including the non-renewal of unprofitable accounts, was initiated in late 2008 and has continued in 2009. As a direct result of poor underwriting results in this marine class, we increased IBNR reserves on current and prior accident years for the affected coverages. These additions negatively impacted the segment's underwriting results for the third quarter by \$4.2 million. On a positive note, reserves for the 2008 hurricanes continued to trend favorably, resulting in \$0.6 million in favorable reserve development in the quarter. From a comparative standpoint, results for 2008 included \$22.5 million in property losses from Hurricanes Gustav and Ike.

Segment results for 2009 translate into a combined ratio of 90.2, compared to 130.4 for the same period last year. The segment's loss ratio decreased to 48.7 from 91.8 in 2008, which was impacted by the aforementioned hurricane losses. From an expense standpoint, the segment's expense ratio for the third quarter was 41.5 for 2009, compared to 38.6 in 2008.

Surety

The surety segment recorded gross premiums written of \$25.4 million for the third quarter of 2009, an increase of \$3.7 million, or 17%, from the same period last year. Premium growth was experienced across fidelity, contract and miscellaneous lines, while commercial and energy writings declined slightly. Our fidelity division, which launched in September 2008, added gross premiums written of \$2.2 million in the third quarter of 2009. Premiums written for contract surety increased by \$1.6 million, driven largely by geographic expansion. The surety segment recorded underwriting income of \$1.7 million, compared to \$7.7 million for the same period last year. Results for 2008 include favorable loss development on prior accident years, primarily 2007, which led to reserve releases during the third quarter of 2008. These reserve releases improved the segment's underwriting results by \$4.9 million.

The combined ratio for the surety segment totaled 90.6 for the third quarter of 2009, versus 55.8 for the same period in 2008. The segment's loss ratio was 22.4 for 2009, compared to -8.6 for 2008, as 2008 was favorably impacted by the aforementioned favorable reserve development. The expense ratio was 68.2 compared to 64.4 for the same period last year, reflective of increased investment in product expansion.

INVESTMENT INCOME AND REALIZED CAPITAL GAINS

Our investment portfolio generated net dividend and interest income of \$16.3 million during the third quarter of 2009, a decrease of 17.9% from that reported for the same period in 2008. The decrease in income is due to exiting higher yielding securities such as preferred stocks and a high yield municipal bond fund earlier in the year. On an after-tax basis, investment income decreased by 19.4%.

Yields on our fixed income investments for the third quarter of 2009 and 2008 are as follows:

	3Q 2009	3Q 2008
<u>Pretax Yield</u>		
Taxable	4.72%	5.50%
Tax-Exempt	3.97%	4.06%
<u>After-tax yield</u>		
Taxable	3.07%	3.58%
Tax-Exempt	3.76%	3.85%

We recognized \$7.0 million in realized gains in the third quarter of 2009, compared to realized losses of \$24.2 million in the third quarter of 2008. Investment gains during the quarter primarily relate to the sale of previously

considered other-than-temporarily impaired securities that had exhibited some recovery, as well as sales of some municipal bonds that were lower quality relative to others in our portfolio. As previously indicated, our OTTI charges relate to securities we no longer have the intent to hold until recovery thus these securities were subsequently sold.

We did not record any realized losses associated with OTTI of securities during the third quarter of 2009.

At September 30, 2009, we did not impair any securitized fixed income bonds. All of these securities are rated AAA by a major rating agency, continue to pay contractual interest payments as agreed, and no security had an unrealized loss greater than 20% of amortized cost. In addition, our cash flow projections indicate that we fully expect to recover the amortized cost basis with no credit loss to principal.

In the third quarter of 2008, there were \$32.2 million in losses associated with impaired securities.

INCOME TAXES

Our effective tax rate for the third quarter of 2009 was 29% compared to -12% for the same period in 2008. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for third quarter of 2009 is the result of increased underwriting and investment results. In the third quarter of 2008, we experienced hurricane losses, which negatively impacted underwriting income, as well as realized losses on our investment portfolio. These factors, combined with an increase in the permanent tax reductions (mainly attributable to the Maui Jim dividend received), resulted in a negative effective tax rate for the third quarter of 2008.

Our net earnings include equity in earnings of an unconsolidated investee. This investee does not have a pattern of paying dividends. As a result, we record a deferred tax liability on these earnings at the corporate capital gains rate of 35%. In the third quarter of 2008, we received a \$4.0 million dividend from Maui Jim. As required by accounting guidance on income taxes, we recognized a \$1.1 million tax benefit from applying the lower tax rate applicable to affiliated dividends as compared to the corporate gains rate on which the deferred tax liabilities were based. This benefit was included in the total dividend received deduction caption in the table below. We recorded no such tax benefit in the third quarter of 2009.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the third quarter of 2009 and 2008 as a result of the following:

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(in thousands)	2009		2008	
	Amount	%	Amount	%
Provision for income taxes at the Statutory rate of 35%	\$ 15,282	35%	\$ 2,694	35%
Increase (reduction) in taxes resulting from:				
Tax exempt interest income	(1,255)	-3%	(1,660)	-22%
Dividends received deduction	(346)	-1%	(1,550)	-20%
Dividends paid deduction	(144)	0%	(133)	-2%
Other items, net	(893)	-2%	(241)	-3%
Total tax expense (benefit)	\$ 12,644	29%	\$ (890)	-12%

Other items, net in the table above for 2009 included a \$0.7 million tax benefit recorded to adjust our interim tax rate to our anticipated full year effective rate of 28%. On an interim basis, we are required to book to an expected annual effective tax rate. This process requires that we review the various components of income (loss) and the relating tax expense (benefit) and adjust the interim effective tax rate to reflect our anticipated annual effective rate. During the first quarter of 2009, we experienced \$33.5 million in net realized investment losses. In relation to earnings from operations, these losses represented a significantly higher percentage than we would expect for the full year and resulted in the need to increase the interim effective tax rate and corresponding tax expense. In essence, we were unable to recognize the full tax benefit of realized investment losses. Since the first quarter, we recorded \$12.7 million of net realized investment gains and substantially higher earnings from operations. As a result, we were able to recognize additional tax benefit on the investment losses recorded during the first quarter. This benefit was recognized by reducing the effective tax rate adjustment (tax expense) from \$2.5 million in the first quarter to \$0.1 million as of the end of the third quarter.

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.

Over the past several quarters, there were significant disruptions in the financial markets. These market disruptions resulted in a lack of liquidity within the credit markets, which increased credit risk in the financial markets and resulted in the widening of credit spreads. Over the most recent quarter, these credit spreads have tightened which favorably impacted our fixed income portfolio.

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, over 90% rated A or better by at least one nationally recognized rating organization.

On an overall basis, our exposure to market risk has not significantly changed from that reported in our December 31, 2008 Annual Report on Form 10-K.

ITEM 4. Controls and Procedures

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

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

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

PART II - OTHER INFORMATION

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

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

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

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

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Our common stock repurchase program, which authorized us to repurchase up to \$100 million of our Company's common stock, was initially approved by our Board of Directors on May 3, 2007. On November 14, 2007, our Board of Directors increased the previously announced repurchase program by \$100 million, for a total of \$200 million of our common stock. The repurchase program may be suspended or discontinued at any time without prior notice. In light of market volatility in the second half of 2008, the repurchase program was suspended in the third quarter of 2008. The repurchase program remained suspended through the third quarter on 2009. On October 19, 2009, we announced that our repurchase program was being re-activated.

Item 3. Defaults Upon Senior Securities Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders 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

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/Joseph E. Dondanville
Joseph E. Dondanville
Sr. Vice President, Chief Financial Officer
(Principal Financial and
Chief Accounting Officer)

Date: October 28, 2009

