RLI CORP
Form S-3
November 07, 2002

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As filed with the Securities and Exchange Commission on November 7, 2002

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM S-3

REGISTRATION STATEMENT
Under
the Securities Act of 1933

RLI CORP.

(Exact name of registrant as specified in its charter)

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

9025 N. Lindbergh Dr., Peoria, Illinois, 61615, (309) 692-1000
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Kim J. Hensey
Vice President and Corporate Secretary
RLI Corp.
9025 N. Lindbergh Dr., Peoria, Illinois, 61615, (309) 692-1000
(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If delivery of the prospectus is expected to be made pursuant to Rule 434, check the following box. o

CALCULATION OF REGISTRATION FEE

Title of each class of securities to be registered	Amount to be registered(1)	Proposed maximum offering price per unit(2)	Proposed maximum aggregate offering price	Amount of registration fee
Common stock, par value $1.00 per share	5,520,000	$28.06	$154,891,200	$14,251

(1) Includes 720,000 shares subject to the exercise of the underwriters' over-allotment option.

(2) Calculated in accordance with Rule 457(c) under the Securities Act of 1933, based on $28.06, the average of the high and low prices of the common stock on the New York Stock Exchange on November 5, 2002.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to Section 8(a), may determine.

SUBJECT TO COMPLETION, DATED NOVEMBER 7, 2002

The information contained in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities, and we are not soliciting offers to buy these securities in any jurisdiction where the offer or sale is not permitted.

4,800,000 Shares
Common Stock

We are offering 4,800,000 shares of our common stock. Our common shares are traded on The New York Stock Exchange under the symbol "RLI." The last reported sale price of the shares on November 6, 2002 was $28.22 per share.

Investing in our common stock involves risks. For more information, see "Risk Factors" beginning on page 8 of this prospectus.

	Per share	Total
Public offering price	$	$
Underwriting discounts and commissions	$	$
Proceeds to us, before expenses	$	$

To the extent that the underwriters sell more than 4,800,000 common shares, we and the selling shareholder have granted the underwriters an option for a period of 30 days to purchase up to 420,000 additional common shares from us and 300,000 additional common shares from the selling shareholder at the public offering price, less the underwriting discount, to cover over-allotments, if any.

The underwriters expect to deliver the shares against payment on or about , 2002.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is , 2002.

Friedman Billings Ramsey **Credit Suisse First Boston**

Cochran, Caronia & Co. **Ferris, Baker Watts**
Incorporated

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You should rely only on the information contained in this document or to which this document refers you. We have not, and the underwriters have not, authorized anyone to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We, the selling shareholder and the underwriters are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus is accurate only as of the date of this prospectus. Our business, financial condition, results of operations and prospects may have changed since that date.

NOTE ON FORWARD LOOKING STATEMENTS

This prospectus contains and incorporates by reference forward-looking statements. Forward-looking statements may be identified by the use of terms such as "believes," "expects," "estimates," "may," "intends," "plans," "will," "should," or "anticipates" or the negative of those terms or similar expressions or by discussions of strategy. We have based our forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to risks, uncertainties and assumptions about us, including:

- the occurrence of man-made or natural catastrophic events;
- the occurrence of significant changes in products or adverse changes in insurance and financial market conditions;
- changing legal and social trends and the inherent uncertainties of the reserving process;
- the ability to collect reinsurance recoverables;
- changes in the availability, cost or quality of reinsurance;
- developments in domestic and international financial markets that could affect our investment portfolios;
- changes in the distribution or placement of risks due to increased consolidation of insurance and reinsurance brokers;
- uncertainties and changes in government policy, regulatory policy, statutory law or case law, with respect to our companies, brokers or customers, that can impede our ability to charge adequate rates and efficiently allocate capital;
- the loss of the services of any of our executive officers or underwriters;
- changing rates of inflation and other economic conditions; and
- the effects of mergers, acquisitions and divestitures.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this prospectus might not occur. You are cautioned not to place undue reliance on any forward-looking statements, which speak only as of their dates.

PROSPECTUS SUMMARY

This summary highlights information about us and the offering. Because this is a summary, it may not contain all the information that you should consider before investing in our common shares. You should carefully read this entire prospectus, especially the "Risk Factors" beginning on page 8 of this prospectus, the consolidated financial statements and notes to those statements and the documents incorporated by reference in this prospectus. When we use the terms "RLI," "we," "us," or "our," we are referring to RLI Corp. together with its consolidated subsidiaries, unless the context otherwise requires. Unless otherwise indicated, all share and per share data in this prospectus has been adjusted to reflect the two-for-one stock split of our common shares in the form of a stock dividend paid on October 15, 2002. Unless otherwise specified, all information in this prospectus assumes no exercise of the underwriters' option to purchase additional shares.

Who We Are

We are a specialty property and casualty insurer operating on both an admitted and excess and surplus basis. Our business objective is to provide fundamentally innovative casualty, property and surety insurance products and services not generally available in the marketplace. As a "niche" company, we offer specialty insurance products designed to meet specific insurance needs of targeted insured groups. These targeted insured markets are often not served or are underserved by standard companies. Typically, the development of these specialty insurance products is generated internally or through proposals brought to us by agents, brokers or reinsurers seeking coverage for a specific group of clients. We attempt to combine profitable underwriting, solid investment returns and effective capital management to deliver consistent, long-term growth in shareholder value. The interests of our skilled and experienced management team are aligned with those of our shareholders through compensation programs that reward long-term, profitable underwriting and performance.

We develop innovative coverages designed to meet specific needs, create highly automated, self-underwriting products, and bring high levels of service to underserved customers. We also utilize technology to allow our business partners to conduct business with us directly, either by submitting business for underwriting consideration or, in many cases, binding and issuing policies direct from their own offices.

What We Do

Our business can be divided into three segments:

	Gross Premiums Written			Net Premiums Earned		
	Year ended December 31,			Year ended December 31,		
	2001	2000	1999	2001	2000	1999
Casualty	$ 288,577	$ 233,937	$ 183,853	$ 156,970	$ 136,801	$ 118,472
Property	169,953	160,508	124,818	70,764	60,063	51,390
Surety	53,455	43,421	30,904	45,274	34,739	25,412
Total	$ 511,985	$ 437,866	$ 339,575	$ 273,008	$ 231,603	$ 195,274

Our casualty segment primarily underwrites general liability, transportation, commercial and personal umbrella, executive products, and other specialty coverages. Our casualty products have a longer payout pattern, or "tail", compared to our other segments. This enables us to hold policyholders' premiums for a longer time on average, which provides increased opportunity to generate investment returns. Our combined ratio in our casualty segment has averaged 101.7 over the last five years.

Our property segment primarily underwrites commercial fire, commercial earthquake and construction risks nationwide and select personal lines policies in the state of Hawaii. We are a leading provider of commercial earthquake insurance in California, having written over $1 billion in gross premiums since we entered this business in 1984. We employ consistent, individual-risk underwriting standards and sophisticated modeling techniques and reinsurance to manage our business and to control exposure levels. Our combined ratio in our property segment has averaged 75.1 over the last five years.

Our surety segment specializes in writing small- and medium-sized commercial and small contract surety products, as well as bonds for the energy and refining industries. Through a highly advanced level of automation, we provide faster customer service by way of bond issuance at the agent's office and a unique direct bill capability. Our combined ratio in our surety segment has averaged 94.9 over the last five years.

Strategy

Opportunistic Growth Our strategy is to ensure that the growth in each product line is consistent with our level of expertise and, most importantly, profitable in nature. We are a product-driven company, continually searching for profitable growth opportunities. We look for opportunities that involve a specialized need or "niche" in the marketplace, as we do not typically compete directly with the large carriers. We rely on our skilled and experienced professionals to identify lines of business that are not driven by distribution channel constraints or demands. While we are flexible enough to take advantage of new opportunities, we are not in the business of turning around struggling companies. Over the past several years we have undertaken several new ventures. These include starting up new lines of business, such as our commercial transportation, program and construction books; purchasing a book of homeowners business from the Hawaii Property Insurance Association; purchasing a small specialty surety company located in Houston, Texas; and expanding our branch office network across the country.

Focused Product Management Our focus on product management is the underpinning of our strategies for growth and profitability. Although many of our branch offices house underwriters of various products, we manage on a product line basis, rather than geographically. Each of our products is led by a capable underwriting vice president in the field and is supported by claim professionals and home office support staff dedicated to its success. Our underwriters are compensated on the profitability, not the growth, of their own books of business. Underwriter bonuses are based on the value created by their own line of business, and are typically paid out over five to eight years, depending upon the length of each product's tail. These payout terms encourage underwriters to manage their business for the long-term, align their interests with those of our shareholders, and allow us to retain our underwriting talent.

Shareholder Alignment Compensation of our key executives is tied to growth in book value, which incorporates both underwriting and investment income streams. In addition, each of our employees has bonus opportunities that are also tied to growth in book value. Our employees' primary retirement plan is our Employee Stock Ownership Plan, or ESOP. Our employees own 13.2% of our outstanding common shares through the ESOP, and directors and executive officers own an additional 8.6% of our outstanding common shares outside of the ESOP.

Operating History

We have a long record of profitable performance. We have reported an underwriting profit in 21 of the 25 years we have been in the property and casualty industry. During this time, the average statutory combined ratio has been 94.5 and we have been below 100 for the last six years. We strive to maintain a consolidated combined ratio below 100 and to beat the annual industry average by a

minimum of 10 percentage points. In the last 10 years, we have outperformed the industry by an average of 12.8 points. Premium volume has increased consistently over this period, but not at the expense of underwriting profitability. In the last ten years, we have had only two years with a combined ratio over 100 (1994 and 1995, as a result of the Northridge, California earthquake).

For the 10 years ended December 31

	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
	(amounts in thousands, except per share data)									
Gross Premium Written	$ 511,985	$ 437,866	$ 339,575	$ 291,073	$ 278,843	$ 276,801	$ 271,436	$ 279,428	$ 249,369	$ 205,643
Net Premium Earned	$ 273,008	$ 231,603	$ 195,274	$ 142,324	$ 141,884	$ 130,656	$ 133,468	$ 140,184	$ 125,989	$ 103,177
GAAP Loss ratio	57.1	53.8	49.4	45.4	43.2	52.2	64.4	72.5	63.3	60.3
GAAP Expense ratio	40.1	41.0	41.8	42.8	43.6	35.2	43.1	44.4	33.9	31.1
GAAP Combined ratio	97.2	94.8	91.2	88.2	86.8	87.4	107.5	116.9	97.2	91.4
Industry Combined Ratio(1)	115.9	110.1	107.8	105.6	101.6	105.8	106.4	108.4	106.9	115.7
Book value per share	$ 16.92	$ 16.66	$ 14.84	$ 14.22	$ 12.35	$ 10.23	$ 8.08	$ 6.68	$ 7.30	$ 6.52

(1) Source: A.M. Best Aggregate & Averages Property-Casualty (2002 Edition), Statutory Basis

We have leveraged our underwriting profitability by conservatively investing a portion of our invested assets in a common stock portfolio designed to have an overall volatility below that of the S&P 500 Index. The remainder of our invested assets are in fixed income securities that are predominately rated AA or better. Our common stock portfolio has generated significant net unrealized gains over the years, and has posted an annualized return of 13.6% since 1982. Our five and ten year weighted average return on our total portfolio at December 31, 2001 was 7.2% and 8.0%, respectively. We have grown our total investments from $281 million at December 31, 1992 to $868 million at September 30, 2002, a compound annual growth rate of 12.3%.

Our consistent underwriting performance and long-term investment results have driven book value per share growth from $6.52 in 1992 to $16.92 in 2001, an 11.2% compound annual growth rate. Over the same period, we returned more than $124 million to shareholders through dividends and share buybacks which, when included with the growth in our book value, brings our compound annual growth rate since 1992 to 16.0%.

Market Outlook and Growth Opportunities

During the 1990s and into 2000, the insurance industry maintained excess capacity, creating highly competitive market conditions. The result was declining premium rates and, in many cases, policy terms less favorable to the insurer. In turn, the industry suffered from reduced profitability and capacity contraction as insurers chose, or were forced, to exit the marketplace. Beginning in the second half of 2000 and continuing through the first nine months of 2002, reduced insurance and reinsurance supply, combined with increased demand, caused premium rates and policy terms to significantly improve. We experienced rate increases across all product lines during 2001 and into 2002. The rate of change in pricing has increased considerably since the events of September 11, 2001, and we believe that rate increases will continue. Also, rate and policy terms flexibility from our surplus lines company has become more attractive for many of our products in the current market environment.

We enter new markets or expand underwriting facilities only after we have acquired the appropriate underwriting talent for that endeavor. By investing in talented underwriters and aligning them with experienced claims professionals, we can be more selective when evaluating risks, which has resulted in lower losses on average than the industry.

Additional capital raised from this offering will be used to support continued growth of our insurance operations and to capitalize on current favorable trends, including firming prices and

increased opportunity to write specialty business. In addition, portions of the proceeds may be used to selectively reduce our use of reinsurance and to pay down our line of credit.

Corporate Information

We are an Illinois corporation with our principal executive offices located at 9025 N. Lindbergh Drive, Peoria, Illinois 61615. Our telephone number at that location is (309) 692-1000. We write multiple lines insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. We write surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. We are rated "A" (Excellent) with a stable outlook by A.M. Best and rated "A+" with a negative outlook by Standard & Poor's.

THE OFFERING

Common shares offered	4,800,000 common shares
Common shares outstanding after this offering	24,675,631 common shares outstanding
Use of proceeds	We will use proceeds from this offering to support expected growth in our insurance operations, to repay indebtedness under our line of credit and for other corporate purposes.
Risk factors	

	See "Risk Factors" and other information included in this prospectus for a discussion of factors you should consider before deciding to invest in common shares.
New York Stock Exchange Symbol	RLI

The number of our common shares outstanding after this offering is based on the number of shares outstanding as of October 31, 2002 and does not include 960,381 shares issuable upon exercise of outstanding options, which are exercisable as of October 31, 2002 at a weighted-average exercise price of $14.65 per share.

SUMMARY FINANCIAL INFORMATION

	As of and for the nine months ended September 30		As of and for the years ended December 31				
	2002	2001	2001	2000	1999	1998	1997
			(amounts in thousands, except per share data)				
OPERATING RESULTS							
Gross Sales	$ 559,100	$ 407,422	$ 548,331	$ 469,759	$ 370,057	$ 316,863	$ 306,383
Total Revenue	271,712	227,036	309,354	263,496	225,756	168,114	169,424
Net earnings	24,699	23,237	31,047	28,693	31,451	28,239	30,171
Comprehensive earnings (loss)(1)	(7,334)	(2,726)	11,373	42,042	20,880	51,758	66,415
Net cash provided from operating activities	120,843	54,908	77,874	53,118	58,361	23,578	35,022
Net premiums written to statutory surplus	101%	89%	109%	84%	79%	46%	54%
GAAP combined ratio	96.1	97.4	97.2	94.8	91.2	88.2	86.8
Statutory combined ratio	91.8	96.9	95.8	95.8	90.1(5)	88.4	90.4
FINANCIAL CONDITION							
Total investments	$ 867,576	$ 754,794	$ 793,542	$ 756,111	$ 691,244	$ 677,294	$ 603,857
Total assets	1,584,986	1,308,102	1,390,970	1,281,323	1,170,363	1,012,685	911,741
Unpaid losses and settlement expenses	704,334	551,569	604,505	539,750	520,494	415,523	404,263
Total debt	87,416	66,384	77,239	78,763	78,397	39,644	24,900
Total shareholders' equity	323,219	318,814	335,432	326,654	293,069	293,959	266,552
Statutory surplus	300,193	263,586	289,997	309,945	286,247	314,484	265,526
SHARE INFORMATION(2)							
Net earnings per share:							
Basic	1.24	1.18	1.58(4)	1.46	1.55	1.34	1.45
Diluted	1.21	1.16	1.55(4)	1.44	1.54	1.33	1.33
Comprehensive earnings (loss) per share:(1)							
Basic	(0.37)	(0.14)	0.58(4)	2.14	1.03	2.46	3.19
Diluted	(0.37)(3)	(0.14)	0.57(3)(4)	2.11	1.02	2.43	2.88
Cash dividends declared per share	0.26	0.24	0.32	0.30	0.28	0.26	0.24
Book value per share	16.27	16.24	16.92	16.66	14.84	14.22	12.35
Closing stock price	26.83	20.50	22.50	22.35	17.00	16.63	19.93
Stock split	200%					125%	
Weighted average shares outstanding:							
Basic	19,852	19,628	19,630	19,634	20,249	21,028	20,804
Diluted	20,426	20,010	20,004	19,891	20,444	21,276	23,428
Common shares outstanding	19,872	19,630	19,826	19,608	19,746	20,670	21,586

(1) See Note 1.M. to our audited consolidated financial statements.

(2) On October 15, 2002, our stock split on a 2-for-1 basis. All share and earnings per share data has been retroactively stated to reflect this split.

(3) Diluted comprehensive earnings per share were antidilutive. As such, diluted and basic comprehensive earnings per share were equal.

(4) Basic and diluted earnings per share include $0.04 per share from the initial application of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities."

(5) The statutory combined ratio presented includes the results of Underwriters Indemnity Company (UIC) and Planet Indemnity Company (PIC) only from the date of acquisition, January 29, 1999.

RISK FACTORS

In addition to the matters addressed in the section entitled "Note On Forward-Looking Statements" and other information included or incorporated in this document, interested investors should consider the following risk factors in determining whether to purchase securities described in this prospectus.

Catastrophic losses could adversely affect our results of operations, liquidity and financial condition.

The greatest risk of loss we face in the ordinary course of our business is property damage resulting from catastrophic events, particularly earthquakes in California and hurricanes and tropical storms affecting Hawaii or the U.S. mainland. Approximately 44% of our 2001 total property premiums were written in California. Most of our past catastrophe-related claims have resulted from earthquakes and hurricanes. For example, in 1994 and 1995, we incurred a total net loss of $30 million related to the Northridge earthquake. Catastrophes can also be caused by various events, including windstorms, hailstorms, explosions, severe winter weather and fires and may include terrorist events such as the attacks on the World Trade Center and the Pentagon on September 11, 2001. The incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophes are restricted to fairly specific geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. Catastrophes can cause losses in a variety of our property and casualty lines, and it is possible that a catastrophic event or multiple catastrophic events could have a material adverse effect upon our results of operations, liquidity and financial condition.

Actual insured losses may be greater than our loss reserves, which would negatively impact our financial condition and results of operations.

Significant periods of time often elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities representing estimates of amounts needed to pay reported and unreported losses and the related loss adjustment expense. Loss reserves are just an estimate of what we anticipate the ultimate costs of claims to be and do not represent an exact calculation of liability. Estimating loss reserves is a difficult and complex process involving many variables and subjective judgments. As part of the reserving process, we review historical data and consider the impact of various factors such as:

- trends in claim frequency and severity;
- changes in operations;
- emerging economic and social trends;

inflation; and

changes in the regulatory and litigation environments.

This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. There is no precise method, however, for evaluating the impact of any specific factor on the adequacy of reserves, and actual results are likely to differ from original estimates. If the actual amount of insured losses is greater than the amount we have reserved for these losses, our financial condition and results of operations could suffer. See "Business-Losses and Settlement Expenses" beginning on page 44 and "Business-Legal Proceedings" beginning on page 56.

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

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

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

Market conditions beyond our control determine the availability and cost of the reinsurance protection that we purchase. In addition, the historical results of reinsurance programs and the availability of capital also affect the availability of reinsurance. Our reinsurance facilities are generally subject to annual renewal. We cannot be sure that we can maintain our current reinsurance facilities or that we can obtain other reinsurance facilities in adequate amounts and at favorable rates. If we are unable to renew our expiring facilities or to obtain new reinsurance facilities, either our net exposures would increase, which could increase our costs, or, if we were unwilling to bear an increase in net exposures, we would have to reduce the level of our underwriting commitments, especially catastrophe exposed risks, which would reduce our revenues. As a result of the events of September 11, 2001, we have seen, and expect to continue to see, a significant tightening in pricing and in the terms and conditions for reinsurance that we purchase.

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

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

rising levels of loss costs that we cannot anticipate at the time we price our products;

volatile and unpredictable developments, including man-made, weather-related and other natural catastrophes or terrorist attacks;

changes in the level of reinsurance capacity;

changes in the amount of loss reserves resulting from new types of claims and new or changing judicial interpretations relating to the scope of insurers' liabilities; and

fluctuations in equity markets and interest rates, inflationary pressures and other changes in the investment environment, which affect returns on invested assets and may impact the ultimate payout of losses.

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

Our investment results and, therefore, our financial condition may be impacted by changes in the business, financial condition or operating results of the entities in which we invest, as well as changes

in interest rates, government monetary policies, general economic conditions and overall market conditions.

We invest the premiums we receive from customers until they are needed to pay policyholder claims or until they are recognized as profits. At September 30, 2002, our investment portfolio consisted of $558.5 million in fixed maturity securities, $213.4 million in equity securities and $95.7 million in short term investments. For the nine months ended September 30, 2002, we experienced a $49.1 million pre-tax unrealized loss on our investment portfolio. The 2002 year-to-date loss reflects largely stock market fluctuations experienced during the first nine months of the year. Fluctuations in the value of our investment portfolio can occur as a result of changes in the business, financial condition or operating results of the entities in which we invest, as well as changes in interest rates, government monetary policies and general economic conditions. These fluctuations may, in turn, negatively impact our financial condition.

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

We compete with a large number of other companies in our selected lines of business. We face competition both from specialty insurance companies, underwriting agencies and intermediaries, as well as diversified financial services companies that are significantly larger than we are and that have significantly greater financial, marketing, management and other resources than we do. Some of these competitors also have significantly greater experience and market recognition than we do. We may incur increased costs in competing for underwriting revenues. If we are unable to compete effectively in the markets in which we operate or to expand our operations into new markets, our underwriting revenues may decline.

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

- an increase in capital-raising by companies in our lines of business, which could result in new entrants to our markets and an excess of capital in the industry;

- the enactment of the Gramm-Leach-Bliley Act of 1999, which could result in increased competition from new entrants to our markets;

- the implementation of commercial lines deregulation in several states, which could increase competition from standard carriers for our excess and surplus lines of insurance business;

- programs in which state-sponsored entities provide property insurance in catastrophe prone areas or other "alternative markets" types of coverage; and

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

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

A downgrade in our ratings from A.M. Best and Standard & Poor's could negatively affect our business.

Ratings are a critical factor in establishing the competitive position of insurance companies. Our insurance companies are rated by A.M. Best Company and Standard & Poor's Corporation. A.M. Best and Standard & Poor's ratings reflect their opinions of an insurance company's and an insurance holding company's financial strength, operating performance, strategic position and ability to meet its obligations to policyholders, and are not evaluations directed to investors. Our ratings are subject to periodic review by A.M. Best and Standard & Poor's, and we cannot assure the continued maintenance of our current ratings. In 2002, A.M. Best reaffirmed its "A" (Excellent) rating for the combined entity

of RLI Insurance Company and Mt. Hawley and its "A" (Excellent) rating for each of UIC and PIC. In 2001, Standard and Poor's gave us an "A+" rating for our whole entity, but revised the outlook for the rating to "Negative" as a result of continued catastrophic risk exposure. Because these ratings have become an increasingly important factor in establishing the competitive position of insurance companies, if our ratings are reduced from their current levels by A.M. Best and/or Standard & Poor's, our competitive position in the industry, and therefore our business, could be adversely affected. A significant downgrade could result in a substantial loss of business as policyholders might move to other companies with higher claims-paying and financial strength ratings.

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

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

- approval of policy forms and premium rates;
- standards of solvency, including risk-based capital measurements;
- licensing of insurers and their agents;
- restrictions on the nature, quality and concentration of investments;
- restrictions on the ability of our insurance company subsidiaries to pay dividends to us;
- restrictions on transactions between insurance company subsidiaries and their affiliates;
- restrictions on the size of risks insurable under a single policy;
- requiring deposits for the benefit of policyholders;
- requiring certain methods of accounting;
- periodic examinations of our operations and finances;
- prescribing the form and content of records of financial condition required to be filed; and

requiring reserves for unearned premium, losses and other purposes.

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

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

We are an insurance holding company and, therefore, may not be able to receive dividends from our insurance subsidiaries in needed amounts.

At the holding company level, our principal assets are the shares of capital stock of our insurance company subsidiaries. We may rely on dividends from our insurance company subsidiaries to meet our obligations for paying principal and interest on outstanding debt obligations, dividends to shareholders and corporate expenses. The payment of dividends by our insurance company subsidiaries will depend on the surplus and future earnings of these subsidiaries and is also subject to regulatory restrictions. The maximum dividend distribution is limited by Illinois law to the greater of 10% of RLI Insurance Company's policyholder surplus as of December 31 of the preceding year or its net income for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend distribution that can be paid by RLI Insurance Company during 2002 without prior approval is $29.0 million, or 10% of RLI Insurance Company's 2001 policyholder surplus. As a result, we may not be able to receive dividends from our subsidiaries at times and in amounts necessary to meet our debt service obligations or to pay dividends to our shareholders or corporate expenses.

We may be unable to attract and retain qualified employees.

We depend on our ability to attract and retain qualified executive officers, experienced underwriting talent and other skilled employees who are knowledgeable about our business. If the quality of our executive officers, underwriting team and other personnel decreases, we may be unable to maintain our current competitive position in the specialized markets in which we operate and unable to expand our operations into new markets.

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

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

- have the effect of delaying, deferring or preventing a change in control of us;
- discourage bids for our securities at a premium over the market price;
- adversely affect the market price of, and the voting and other rights of the holders of, our securities; or
- impede the ability of the holders of our securities to change our management.

See "Description of Capital Stock" for a summary of these provisions.

USE OF PROCEEDS

We plan to use the net proceeds from the sale of the common shares to support expected growth in our insurance operations, to repay indebtedness under our line of credit and for general corporate purposes, including acquisitions. Indebtedness under our line of credit was borrowed in six tranches with a weighted-average interest rate of 2.63%, and all amounts outstanding under our line of credit are due within five months of the date of this prospectus.

CAPITALIZATION

The table below shows our capitalization on a consolidated basis as of September 30, 2002. The "As Adjusted" column reflects our capitalization after giving effect to this offering of common shares

and our use of the net proceeds to us from the offering, based upon a public offering price of $28.22 per share (the last reported sale price of our common stock on November 6, 2002, as reported on the New York Stock Exchange) after deducting underwriting discounts and commissions and offering expenses, and assuming no exercise of the underwriters' option to purchase additional shares.

You should read this table along with our audited financial statements included with this prospectus as well as the information presented in our Quarterly Reports on Form 10-Q. See "Where You Can Find More Information About Us."

	As of September 30, 2002	
	Actual(1)	**As Adjusted**
	(Unaudited) (In thousands, except share data)	
Short-term debt, LOC and notes payable	$ 87,416	$ 47,416
Shareholders' equity:		
Common stock, par value $1.00 per share, 50,000,000 authorized; 25,669,350 shares issued and outstanding, actual; and 30,469,350 shares issued and outstanding, as adjusted	$ 25,669	$ 30,469
Paid-in capital	60,472	184,078
Accumulated other comprehensive earnings net of tax	61,443	61,443
Retained earnings	256,641	256,641
Deferred compensation	5,441	5,441
Treasury stock, at cost (5,797,516 shares)	(86,447)	(86,447)
Total shareholders' equity	323,219	451,625
Total capitalization	$ 410,635	$ 499,041
Debt to total capitalization ratio	21%	10%

(1) On October 15, 2002, our common stock split on a two-for-one basis. Shareholders' equity, as presented above, has been stated to reflect this split.

SELECTED FINANCIAL INFORMATION

The information as of and for each of the years in the five-year period ended December 31, 2001 has been derived from and should be read in conjunction with our audited consolidated financial statements and footnotes included in and incorporated by reference into this prospectus. The information as of and for the nine months ended September 30, 2002 and 2001 is unaudited and has been derived from our unaudited consolidated financial statements included in and incorporated by reference into this prospectus. See "Where You Can Find More Information About Us."

	As of and for the nine months ended September 30		As of and for the years ended December 31				
	2002	2001	2001	2000	1999	1998	1997
	(amounts in thousands, except per share data)						
OPERATING RESULTS							
Gross Sales	$ 559,100	$ 407,422	$ 548,331	$ 469,759	$ 370,057	$ 316,863	$ 306,383
Total Revenue	271,712	227,036	309,354	263,496	225,756	168,114	169,424
Net earnings	24,699	23,237	31,047	28,693	31,451	28,239	30,171
Comprehensive earnings (loss)(1)	(7,334)	(2,726)	11,373	42,042	20,880	51,758	66,415
Net cash provided from operating activities	120,843	54,908	77,874	53,118	58,361	23,578	35,022
Net premiums written to statutory surplus	101%	89%	109%	84%	79%	46%	54%
GAAP combined ratio	96.1	97.4	97.2	94.8	91.2	88.2	86.8
Statutory combined ratio	91.8	96.9	95.8	95.8	90.1(5)	88.4	90.4
FINANCIAL CONDITION							
Total investments	$ 867,576	$ 754,794	$ 793,542	$ 756,111	$ 691,244	$ 677,294	$ 603,857
Total assets	1,584,986	1,308,102	1,390,970	1,281,323	1,170,363	1,012,685	911,741
Unpaid losses and settlement expenses	704,334	551,569	604,505	539,750	520,494	415,523	404,263
Total debt	87,416	66,384	77,239	78,763	78,397	39,644	24,900
Total shareholders' equity	323,219	318,814	335,432	326,654	293,069	293,959	266,552
Statutory surplus	300,193	263,586	289,997	309,945	286,247	314,484	265,526
SHARE INFORMATION(2)							
Net earnings per share:							
Basic	1.24	1.18	1.58(4)	1.46	1.55	1.34	1.45
Diluted	1.21	1.16	1.55(4)	1.44	1.54	1.33	1.33
Comprehensive earnings (loss) per share:(1)							
Basic	(0.37)	(0.14)	0.58(4)	2.14	1.03	2.46	3.19
Diluted	(0.37)(3)	(0.14)	0.57(4)	2.11	1.02	2.43	2.88
Cash dividends declared per share	0.26	0.24	0.32	0.30	0.28	0.26	0.24
Book value per share	16.27	16.24	16.92	16.66	14.84	14.22	12.35
Closing stock price	26.83	20.50	22.50	22.35	17.00	16.63	19.93
Stock split	200%					125%	
Weighted average shares outstanding:							

	As of and for the nine months ended September 30		As of and for the years ended December 31				
Basic	19,852	19,628	19,630	19,634	20,249	21,028	20,804
Diluted	20,426	20,010	20,004	19,891	20,444	21,276	23,428
Common shares outstanding	19,872	19,630	19,826	19,608	19,746	20,670	21,586

(1) See Note 1.M. to our audited consolidated financial statements.

(2) On October 15, 2002, our stock split on a 2-for-1 basis. All share and earnings per share data has been retroactively stated to reflect this split.

(3) Diluted comprehensive earnings per share were antidilutive. As such, diluted and basic comprehensive earnings per share were equal.

(4) Basic and diluted earnings per share include $0.04 per share from the initial application of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities."

(5) The statutory combined ratio presented includes the results of Underwriters Indemnity Company (UIC) and Planet Indemnity Company (PIC) only from the date of acquisition, January 29, 1999.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with this entire prospectus, including the "Risk Factors" section and our consolidated financial statements and the notes to those statements included or incorporated by reference in this prospectus. The discussion and analysis below includes certain forward-looking statements that are subject to risks, uncertainties and other factors described in "Risk Factors" and elsewhere in this prospectus that could cause our actual growth, results of operations, performance and business prospects and opportunities in 2002 and beyond to differ materially from those expressed in, or implied by, those forward-looking statements. See "Note on Forward-Looking Statements."

Overview

We are a holding company that underwrites selected property and casualty insurance through our major subsidiaries collectively known as RLI Insurance Group, or the Group. The Group has accounted for approximately 88% of our consolidated revenue over the last three years and 91% of our consolidated revenue for the first nine months of 2002 by providing property and casualty coverages primarily for commercial risks. As a "niche" company, we offer specialty insurance products designed to meet specific insurance needs of targeted insured groups. These targeted insured markets are often not served or are underserved by standard companies. Typically, the development of these specialty insurance products is generated internally or through proposals brought to us by agents, brokers or reinsurers seeking coverage for a specific group of clients. Our management measures 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 GAAP (accounting principles generally accepted in the United States of America) combined ratios, which are further subdivided into their respective loss and expense components.

The property and casualty insurance business is cyclical and influenced by many factors, including price competition, economic conditions, natural or man-made disasters (for example, earthquakes 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 products 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 exceed recorded amounts; if actual liabilities do exceed recorded amounts, there will be an adverse effect on us.

Our investment strategy is designed to capitalize on our historical ability to generate positive underwriting income. Preservation of capital is the first priority, with a secondary focus on generating total return. The base fixed-income portfolio is rated investment grade, to protect invested assets. Regular underwriting profits allow the majority of our shareholders' equity to be invested in a value-based, large-capitalization common stock portfolio. With the exception of a small warrant position in a private equity investment, the portfolio contains no derivatives or off-balance sheet structured investments. In addition, we employ stringent diversification rules and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite recent realized and unrealized losses in the equity portfolio, the overall portfolio's fairly conservative approach has contributed significantly to our historic growth in book value.

Critical Accounting Policies

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

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation, recoverability of reinsurance balances and deferred acquisition costs.

Unpaid Losses and Settlement Expenses

The liability for unpaid losses and settlement expenses represents estimates of amounts needed to pay reported and unreported claims and related expenses. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined.

Historically, we have not experienced significant development, favorable or unfavorable, either with the liability in total or within industry segments. Additional information with respect to reserve development patterns for individual calendar year ended liabilities can be found on pages 46 and 48 of this prospectus. Adding to the complexities inherent in the reserving process are issues related to coverage, expansion of coverage, and reinsurance program applicability.

We have insignificant exposure to asbestos and environmental policy liabilities, as a result of entering liability lines after the industry had already recognized it as a problem. What exposure does exist is through our commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. The majority of the exposure that does exist is in the excess layers of our commercial umbrella and assumed reinsurance books of business. Although our environmental exposure is limited, management cannot determine our ultimate liability with any reasonable degree of certainty. This ultimate liability is difficult to assess due to evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, we participate primarily in the excess layers, making it even more difficult to assess the ultimate impact.

Investment Valuation

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 and trading securities are carried at fair value.

Our management regularly reviews its fixed maturity and equity securities portfolio to evaluate the necessity of recording impairment losses for other-than-temporary declines in the fair value of investments. A number of criteria are considered during this process including, but not limited to, the current fair value as compared to amortized cost or cost, as appropriate, of the security, the length of time the security's fair value has been below amortized cost/cost, and by how much, credit ratings, current economic conditions, the horizon over which the recovery of cost is expected, and our decisions to hold or divest of a security. In the year ended December 31, 2001, we did not record any charges for the other-than-temporary decline in value of any investments.

In addition, we consider certain factors specific to each company that has issued a security, including profitability, leverage, growth and cash flow. Impairment losses result in a reduction of the

cost basis of the underlying investment. Significant changes in the factors from period to period that we consider when evaluating investments for impairment losses could result in a significant charge for impairment losses reported in the consolidated financial statements.

Recoverability of Reinsurance Balances

Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, instead of being netted with the appropriate liabilities, since reinsurance does not relieve us of our legal liability to our 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. Our policy is to charge to earnings an estimate of unrecoverable amounts from troubled or insolvent reinsurers.

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. These 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, which gives effect to the premium to be earned, related investment income, anticipated losses and settlement expenses and certain other costs expected to be incurred as the premium is earned. Judgments as to ultimate recoverability of such deferred costs are highly dependent upon estimated future loss costs associated with the premiums written.

Operations

Nine Months Ended September 30, 2002, Compared to Nine Months Ended September 30, 2001

Consolidated gross sales, which consist of gross premiums written, net investment income and realized investment gains/losses totaled $559.1 million for the first nine months of 2002 compared to $407.4 million for the same period in 2001. Gross writings of the Group improved 40.7% over 2001 levels fueled by increases in all three business segments. Consolidated net revenue for the first nine months of 2002 increased $44.7 million or 19.7% from the same period in 2001. Net premiums earned increased 23.9%. Net investment income improved 17.9% to $28.1 million. Additionally, the sale of certain securities and the impairment of four equity securities resulted in the recording of $3.8 million in realized losses during the first nine months, compared to realized gains of $3.5 million for the same period last year. In September 2002, we recorded $6.5 million of impairment losses on securities whose market value was deemed to be other-than-temporarily impaired. This adjustment was a reclassification from unrealized losses to realized losses and did not impact operating earnings or comprehensive earnings. For further discussion of this adjustment, see " Investment Income" beginning on page 20.

The net after-tax earnings for the first nine months of 2002 totaled $24.7 million, $1.21 per diluted share, compared to $23.2 million, $1.16 per diluted share, for the same period in 2001. 2001 results include the cumulative-effect adjustment for the initial adoption of SFAS 133, "Accounting for Derivative and Hedging Activities," which totaled $800,415 ($0.04 per diluted share) in net after-tax earnings. Net operating earnings consists of our net earnings reduced by after-tax realized investment gains/losses and cumulative-effect adjustments. Operating earnings depicts more accurately and comparably the results of our ongoing operations, as the excluded realized gains or losses are typically generated through market and tax strategies not related to our near term operating performance objectives. While this measure may not be comparable to the definition of operating earnings used by all companies, it is quite common in the insurance industry. Our net operating earnings totaled

$27.1 million, $1.33 per diluted share, compared to $20.2 million, $1.01 per diluted share, for the same period in 2001. Improved underwriting income, particularly on the property book, coupled with growth in investment income and decreased debt costs, favorably impacted 2002 earnings. During the first nine months of 2002, we implemented SFAS 142, "Goodwill and Other Intangibles." Under this Statement, intangible assets and goodwill with indefinite lives are no longer amortized, but are instead subject to fair value/impairment testing. Implementation of this Statement has favorably improved 2002 earnings by $1.3 million ($0.06 per diluted share), as a result of decreased amortization expense. Investment income improved during 2002 due to strong cash flow and $1.6 million ($0.05 per diluted share) of investment income recorded from the increase in the fair value of warrants, subject to the provisions of SFAS 133. During the first nine months of 2001, $1.0 million ($0.03 per diluted share) of investment income was recorded for these warrants. Additionally, 2001 results were negatively impacted by losses on the property segment, including Seattle earthquake losses, which totaled just under $1.0 million ($0.03 per diluted share). Although the Company had limited exposure to the September 11 terrorist attack, a $500,000 ($0.02 per diluted share) charge for potential costs associated with this event was recorded in September 2001. Through September 2002, a total of ten claims relating to this event had been received. Eight claims were closed with a total incurred loss of $16,000, primarily loss adjustment related. Two claims remain open and relate to commercial business interruption only. We have reserved rights as to whether these claims are covered under the policies. Incurred loss adjustment expense to date on these claims is $64,000. We believe the remaining loss reserves are adequate to cover any remaining exposure.

Comprehensive earnings, which include net earnings plus unrealized gains/losses net of tax, were subject to the volatility in the equity and bond markets. Comprehensive earnings for the first nine months of 2002 totaled a loss of $7.3 million, $0.37 per diluted share, compared to a loss of $2.7 million, $0.14 per diluted share, for the same period in 2001. Unrealized losses, net of tax, for the first nine months of 2002 were $32.0 million, $1.58 per diluted share compared to losses of $26.0 million, $1.30 per diluted share, for the same period in 2001.

RLI Insurance Group

Gross written premium for the Group increased to $534.8 million for the first nine months of 2002 compared to $380.1 million for the same period in 2001. Improved pricing across all three business segments and various growth initiatives have positively impacted gross written premium. Underwriting income improved to a pre-tax profit of $9.6 million for the first nine months of 2002 compared to $5.1 million for the same period in 2001. The GAAP combined ratio declined to 96.1 for the first nine months of 2002, compared to 97.4 for the same period in 2001. The property segment was responsible for the majority of the improved results, as loss experience continues to be down significantly from last year. Additionally, the casualty segment recorded improved earnings from last year. The surety segment's results, however, were negatively impacted by national economic conditions that affected contract surety experience and certain commercial surety claims.

Gross written premiums for the casualty segment were $324.7 million for the first nine months of 2002, up $108.6 million, or 50.3%, from 2001. Growth initiatives and improved pricing contributed to growth in the following products: program business up $60.6 million, general liability up $33.3 million, executive products up $22.7 million, personal umbrella up $5.5 million, and transportation up $5.4 million. Partially offsetting these increases, commercial umbrella declined $19.3 million, due to the re-underwriting of the book. The underwriting loss on the casualty book was $889,000 compared to a loss of $2.0 million for the first nine months 2001. These results translate into a combined ratio of 100.6 in 2002 versus 101.8 for the same period in 2001. The segment's expense ratio at 30.2 has continued to show improvement, as premium volume has continued to increase, while the loss ratio at 70.4 remains stable.

The Group's property segment experienced an increase in gross writings of $37.0 million, or 30.0%, compared to the same period last year. For the first nine months of 2002, property premiums totaled $160.4 million. Fueled by the improved rate environment, difference-in-condition writings improved $15.7 million over 2001, and fire writings grew by $18.7 million. Additionally, construction writings increased $3.4 million to $31.6 million. Underwriting profit for the property segment was $14.0 million for the first nine months of 2002, compared to $4.6 million in 2001. The GAAP combined ratio decreased to 78.3 compared to 91.1 for the same period last year. Furthermore, early indications are that little impact has occurred from either Tropical Storm Isidore or Hurricane Lily. Seattle earthquake losses and loss experience on discontinued property classes negatively impacted 2001 results.

Gross written premiums for the surety segment increased to $49.7 million for the first nine months of 2002, up $9.1 million, or 22.3%, from the same period in 2001. Growth is evident across all surety lines, including contract, oil and gas, commercial and miscellaneous. Commercial surety is up $3.4 million over the first nine months of 2001. This product was launched during the first part of 2001. Contract premium is up $2.3 million over the first nine months of 2001, primarily driven by increased rates. Additionally, oil and gas premium is up $2.0 million over 2001 levels, due to increased commodity prices and achieved rate increases. The surety book reported an underwriting loss of $3.5 million for the first nine months of 2002, compared to an underwriting gain of $2.5 million for the same period last year. The combined ratio for the surety segment totaled 109.3 in 2002 compared to 92.2 in 2001. The expense ratio increased to 64.7 compared to 63.8 last year, primarily due to increased reinsurance costs. The loss ratio component increased to 44.6 compared to 28.4 last year, as a result of national economic conditions that negatively impacted contract surety loss experience and commercial surety claims. We are in litigation regarding certain commercial surety bond claims arising out of a specific bond program. We are currently investigating and evaluating our obligations due to a variety of complex coverage issues. See "Business Legal Proceedings" beginning on page 56.

Investment Income

Our investment portfolio generated net dividends and interest income of $28.1 million during the first nine months of 2002, an increase of 17.9% over that reported for the same period in 2001. Diversification of the fixed income portfolio and continued growth in operating cash flow has resulted in the rise in investment income. Additionally, pursuant to SFAS 133 requirements, we recorded $1.6 million in net investment income during 2002 to recognize the current period change in the fair value of stock warrants received in conjunction with the purchase of a note receivable. This compares to $1.0 million recognized in the same period in 2001. We maintain an equity investment in a private mortgage banking company. As of September 30, 2002, our equity investment, which consisted of common shares and warrants to acquire common shares, had a carrying value and estimated market value of $4.9 million. We employ a consistent valuation formula to recognize investment income or loss each quarter and to adjust the carrying value of our investment. This formula is based on the investee's book value, the volume of mortgages originated and profitability. Further discussion of SFAS 133 and its impact on us can be found in Note 1, Other Accounting Standards, to our unaudited interim consolidated financial statements.

We experienced a net realized loss from investments of $3.8 million in the first nine months of 2002, compared to a net realized gain of $3.5 million for the same period in 2001. Realized losses associated with the impairment of four specific equity securities in the technology and utility sectors resulted in this shift. We regularly evaluate the quality of our investment portfolio. When we believe that a specific security has suffered an other-than-temporary decline in value, the investment's value is adjusted by charging off the loss against income. In the third quarter of 2002, our analysis identified $6.5 million in other-than-temporary declines in value, related to four specific equity positions in the technology and utility sectors. Stocks within the technology sector have been negatively impacted by a slow-down in economic activity in general and in capital spending in particular. Stocks within the utility

sector have been negatively impacted by liquidity, regulatory and legal concerns in the wake of energy trading scandals. As a result, in September 2002, we recorded $6.5 million of impairment losses on these securities. The loss was calculated as the difference between the cost basis and market value as of September 30, 2002. The effect of this adjustment was a reclassification from unrealized losses to realized losses. After the impairment of these securities, cumulative unrealized gains of $94.4 million remained in the investment portfolio. For the same period in 2001, no impairment charges were recorded. Partially offsetting the impairment loss, $2.7 million in net realized gains were recorded from the sale of certain equity and fixed income investments during the first nine months of 2002.

At September 30, 2002, we had exposure to the technology sector within the equity portfolio of $8.8 million at market, representing 4.1% of total equity securities held. Our technology equity position had gross unrealized gains of $0.6 million and gross unrealized losses of $0.3 million for a net unrealized gain of $0.3 million. At September 30, 2002 we had exposure to the utility sector of $42.7 million, representing 20.0% of total equity securities held. Our utility equity position had gross unrealized gains of $8.7 million and gross unrealized losses of $3.4 million for a net unrealized gain of $5.3 million. All other industry sectors in our equity portfolio had a net unrealized gain position as of September 30, 2002. Based on our evaluation of specific securities held within these specific industry sectors and all other sectors, we do not believe any other securities have suffered an other-than-temporary decline in value. As of September 30, 2002, we held $23.7 million worth of equity and fixed income securities that individually had an unrealized loss greater than 10%. The cumulative unrealized loss on these securities was $7.8 million, which represented 0.9% of total invested assets as of September 30, 2002. Our management does not believe that any of these securities are other than temporarily impaired, but additional impairments within the portfolio during the remainder of 2002 are possible, if current economic and financial conditions worsen, and such impairments may be material. For the nine months ended September 30, 2002, we experienced a $49.1 million pre-tax unrealized loss on our investment portfolio.

As of September 30, 2002, 98% of our fixed income portfolio consisted of securities rated A or better, with 87% rated AA or better. 100% of fixed income securities held as of September 30, 2002 were investment grade. The year-to-date yields on our fixed income investments for the nine-month periods ended September 30, 2002 and 2001 are as follows:

	2002	**2001**
Taxable	6.22%	6.55%
Non-taxable	4.87%	4.95%

For the first nine months of 2002, yields on both taxable and non-taxable bonds decreased slightly. The slight decline is attributed to a decrease in treasury yields on the short and intermediate part of the yield curve and to the reinvestment of called and matured bonds at lower yields. Despite the lower treasury yields, the overall impact on the fixed income portfolio has been limited due to sector diversification and continued growth in operational cash flow.

Our available-for-sale portfolio of debt and equity securities had a net unrealized loss before tax of $49.1 million for the first nine months of 2002, compared with a $40.0 million loss for the same period in 2001. The 2002 year-to-date loss reflects largely stock market fluctuations experienced during the first nine months of the year. Our net cumulative unrealized gain before tax was $94.4 million, down from $143.5 million at December 31, 2001. Unrealized appreciation on securities, net of tax, is reflected in accumulated other comprehensive earnings, a component of shareholders' equity.

Interest expense on debt obligations decreased to $1.4 million for the first nine months of 2002, a $1.3 million decrease from the same period in 2001. This change is related to decreased debt costs resulting from falling interest rates, offset by an $8.2 million increase in average outstanding debt. At September 30, 2002, outstanding short-term balances totaled $87.4 million, compared to $66.4 million

at September 30, 2001. At September 30, 2002, short-term debt consisted of $40.0 million under a line of credit and $47.4 under reverse repurchase agreements whereby we borrow on a short-term basis against the value of certain fixed income investments. At September 30, 2001, short-term debt consisted of $19.7 million under a line of credit and $46.7 million under reverse repurchase agreements. We have utilized debt to repurchase shares, facilitate acquisitions, and increase capital in our insurance operating companies. We have incurred interest expense on debt at the following average interest rates for the nine-month periods ended September 30, 2002 and 2001:

	2002	2001
Line of Credit	2.87%	5.65%
Reverse repurchase agreements	2.03%	5.04%
Total debt	2.36%	5.22%

Income Taxes

Our effective tax rate for the first nine months of 2002 and 2001 was 26%. 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 2002 and 2001 as a result of the following:

	2002		2001	
	Amount	%	Amount	%
Provisions for income taxes at the statutory rate of 35%	$ 11,710,892	35%	$ 10,644,133	35%
Increase (reduction) in taxes resulting from:				
Tax exempt interest income	(2,170,366)	(6%)	(2,105,364)	(7%)
Dividends received deduction	(1,145,243)	(4%)	(1,072,998)	(4%)
Dividends paid deduction	(229,324)	(1%)	(209,385)	(1%)
Goodwill amortization	0	0%	416,433	2%
State tax and other items, net	595,034	2%	302,467	1%
Total tax expense	$ 8,760,993	26%	$ 7,975,286	26%

Year Ended December 31, 2001, Compared to Years Ended December 31, 2000 and December 31, 1999, respectively.

Consolidated gross sales for 2001 totaled $548.3 million, a 16.7% increase from 2000, which followed a 26.9% gain over 1999. This trend was driven by gross premiums written growth in 2001 of 16.9%, to a total of $512.0 million, compared to an increase of 28.9% in 2000. This lower rate of growth reflected our exiting several unprofitable lines of business, particularly in the property segment. Robust growth in many ongoing product lines continued in 2001, as shown below in the segment details. Net investment income grew 10.8%, to $32.2 million in 2001, while the 2000 increase was 11.7%. Realized gains were also greater in 2001 by 46.4%, to $4.2 million, compared to a decline of 36.3% in 2000 from 1999.

Gross Sales:	Year Ended December 31, 2001	2000	1999
		(in thousands)	
Gross premiums written	$ 511,985	$ 437,866	$ 339,575
Net investment income	32,178	29,046	26,015
Realized investment gains	4,168	2,847	4,467
Total gross sales	$ 548,331	$ 469,759	$ 370,057

Consolidated revenue for 2001 was $309.4 million, compared to $263.5 million in the prior year and $225.8 million in 1999. Net premiums earned, the main driver of this measurement, continued a steady rate of growth of 17.9% in 2001, following an 18.6% increase in 2000.

Our net earnings were $31.0 million ($1.55 per diluted share) in 2001, compared to $28.7 million ($1.44 per share) in 2000 and $31.5 million ($1.54 per share) in 1999. The 2001 increase, in spite of declining underwriting profits, was a result of increased investment gains and reduced debt interest. The drop in 2000 profits compared to 1999 was almost entirely due to lower underwriting income, but was offset partially by increased investment income and higher investee earnings.

Comprehensive earnings fell sharply in 2001, to $11.4 million from $42.0 million in 2000. Comprehensive earnings in 1999 were $20.9 million. The largest factor in these results is the unrealized gain or loss on the equity portfolio, which posted a 7.2% loss for 2001. Obviously, this result was below expectations but significantly ahead of the broad markets, including the S&P 500, which was down 11.9% in 2001. We continue to emphasize a long-term focus investment strategy, which has not changed despite the year's total return performance. The robust returns in 1997, 1998 and 2000 reflect our commitment to our investment strategy, which management believes will maximize value for our shareholders in the future, as it has done historically, according to the following chart:

Diluted earnings per share:	Net	Comprehensive
1997	$ 1.33	$ 2.88
1998	1.33	2.43
1999	1.54	1.02
2000	1.44	2.11
2001	1.55	0.57
Total	$ 7.19	$ 9.01

As this chart indicates, comprehensive earnings per share for the last five years exceeded reported net earnings by 25%.

RLI Insurance Group

As indicated earlier, gross premiums written increased in each of the last two years, although the 2001 rate of 16.9% was affected by a number of withdrawals from certain product lines, mostly in the property segment; the surety and casualty segments each increased by more than 20%. Over the last three years, underwriting income peaked at $17.1 million in 1999 with a 91.2 combined ratio, followed by underwriting profits of $12.1 million at a 94.8 combined ratio, then $7.7 million at a 97.2 combined ratio for 2000 and 2001, respectively. This trend resulted from higher-than-anticipated loss activity and, in some cases, higher reinsurance costs on specific products across multiple segments. Notably, many of these problems were addressed either through increased underwriting controls or elimination of some products. The positive impact of these actions was evidenced in the fourth quarter of 2001, as the Group posted its best underwriting quarter of the year. Furthermore, these results were achieved during an especially trying year, in which the industry suffered losses from the Seattle earthquake, Hurricane Allison, the terrorist attacks of September 11 and the Enron collapse, serving as a testament to the Group's underwriting skill and expertise.

Gross premiums written:	**2001**	**2000**	**1999**
		(in thousands)	
Casualty	$ 288,577	$ 233,937	$ 183,853
Property	169,953	160,508	124,818
Surety	53,455	43,421	30,904
Total	$ 511,985	$ 437,866	$ 339,575

Underwriting profits:	**2001**	**2000**	**1999**
		(in thousands)	
Casualty	$ (2,187)	$ 3,461	$ (2,328)
Property	7,525	4,990	17,064
Surety	2,336	3,633	2,399
Total	$ 7,674	$ 12,084	$ 17,135

Casualty Segment

Casualty gross premiums written continued to grow substantially; the $288.6 million result in 2001 was a 23.4% increase over the $233.9 million posting in 2000, which compared to $183.9 million in 1999. Several product lines showed double digit growth in both years, including general liability, personal umbrella, executive products, transportation and program business.

The GAAP combined ratio for the casualty segment was 101.4 in 2001, compared to 97.4 in 2000 and 101.9 in 1999. The 1999 and 2001 results were closer to expectations for the casualty segment; the 2000 combined ratio was the result of recognizing reserve redundancies on selected lines, based on favorable loss experience. This action, in conjunction with the conservative approach to a 100-plus combined ratio for this segment on an ongoing basis, supports management's belief that casualty loss reserves will be adequate and investment income derived from reserved funds will provide significant future earnings potential.

Property Segment

The Group's property segment contributed gross premiums written of $170.0 million in 2001, compared to $160.5 million in 2000 and $124.8 million in 1999. The smaller increase in 2001 was the result of non-renewing, or exiting, several unprofitable lines of commercial fire business. This was offset as the Group continued to increase its construction writings, which grew nearly 100%. Difference in conditions premiums were flat in 2001 after having increased 9.6% in 2000. This was the result of managing aggregate exposures through the Group's catastrophe modeling process.

Profitability in the property segment rose to $7.5 million in 2001 from $5.0 million in 2000. The segment reported profits of $17.1 million in 1999. Combined ratios for 2001-1999, respectively, were 89.3, 91.7 and 66.8. The growth in the construction line came at a considerable cost. Despite our expectations of some loss activity ahead of premium earnings, this product's loss ratio of 139 in 2000 far exceeded these expectations. Several underwriting changes were pursued from late 2000 into 2001, including rate and deductible increases, commission restrictions, reinsurance revisions and other types of exposure control. The loss ratio improved to 83 in 2001, leaving considerable opportunity for 2002. Other property lines also experienced somewhat higher loss ratios, particularly during 2000. While the causes in any given line vary considerably, in each case, we evaluate the activity within the context of given time horizons, and take appropriate underwriting action where necessary. Such actions may include the discontinuance of certain lines that do not give indications of long-term profitability. The results of such actions in 2001 resulted in a fourth quarter 2001 underwriting profit, the best posting for this segment in nearly two years.

Surety Segment

Surety gross premiums written increased to $53.5 million in 2001, up 23.1% over 2000. This compared to the 2000 increase over 1999 of 40.5%. The growth in 2000 was due to the combined impact of both contract surety and oil and gas operations, which experienced volume-related gains of 60.4% and 42.3%, respectively. The increase during 2001 was due to the formation of a mid-market commercial surety unit late in 2000, which contributed $9.0 million of growth.

While segment profits peaked in 2000 at $3.6 million, compared to $2.4 million in 1999, they dipped to $2.3 million in 2001 with a combined ratio of 94.9. This compared to ratios of 89.6 and 90.5 in 2000 and 1999, respectively. While the segment has shown steady improvement on the expense side over the last three years, loss ratios have increased from 19.5% in 1999 to 23.9% in 2000 and 31.4% in 2001. The contract bond sector of this business has experienced losses beyond expectations related to the economic slowdown over the last several quarters.

Investment Income

Net investment income increased by 10.8% during 2001 due to increased cash flow allocated to fixed-income investments and the recognition of $1.6 million of investment income (per the application of SFAS 133, as discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations Accounting Standards" beginning on page 32) associated with warrants owned in private equity investments. We maintain an equity investment in a private mortgage banking company. As of December 31, 2001, our equity investment, which consisted of common shares and warrants to acquire common shares, had a carrying value and estimated market value of $3.4 million. We employ a consistent valuation formula to recognize investment income or loss each quarter and to adjust the carrying value of our investment. This formula is based on the investee's book value, the volume of mortgages originated and profitability.

On an after-tax basis, investment income increased by 9.0%. We realized $4.2 million in capital gains in 2001, compared to $2.8 million in 2000 and $4.5 million in 1999. Operating cash flows were $77.9 million in 2001, up from $53.1 million and $58.4 million in 2000 and 1999, respectively. Cash flows in excess of current needs were used to purchase fixed-income securities, which continue to be comprised primarily of U.S. government and government agency, high-grade tax-exempt and corporate issues.

Pretax yield:	**2001**	**2000**	**1999**
Taxable (on book value)	6.49%	6.75%	6.57%
Tax-exempt (on book value)	4.96%	4.92%	4.78%
Equities (on market value)	2.60%	2.30%	2.43%
After-tax yield:			
Taxable (on book value)	4.22%	4.39%	4.27%
Tax-exempt (on book value)	4.70%	4.66%	4.53%
Equities (on market value)	2.23%	1.96%	2.07%

During 2001, the average tax-equivalent yield of the portfolio decreased five basis points (7.01% vs. 7.06%), due to decreases in both taxable and tax-exempt yields on new purchases. During the year, we again focused on purchasing high-quality investments, including corporate bonds, mortgage backed securities and asset backed securities, primarily in the 0-10 year part of the yield curve.

Our fixed-income portfolio increased by $60.5 million during the year. This portfolio had realized gains of $2.2 million and a tax-adjusted total return on a mark-to-market basis of 8.3%. Our equity portfolio decreased by $28.6 million during 2001, to $277.6 million. For the year, this portfolio had pretax portfolio depreciation of $30.8 million and realized capital gains of $1.9 million. For the year, the total loss on this portfolio was 7.2%. The total return for the consolidated portfolio (fixed income and equity) for 2001 was 2.0%.

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

Year	**Average Invested Assets(1)**	**Investment Income(2)(3)**	**Realized Gains(3)**	**Change in Unrealized Appreciation (3)(4)**	**Annualized Return on Average Invested Assets**	**Tax Equivalent Annualized Return on Average**

						Invested Assets
			(in thousands)			
1997	$ 570,901	$ 24,558	$ 2,982	$ 55,760	14.6%	15.5%
1998	640,576	23,937	1,853	36,183	9.7%	10.6%
1999	684,269	26,015	4,467	(16,263)	2.1%	3.0%
2000	723,677	29,046	2,847	20,537	7.2%	8.1%
2001	774,826	32,178	4,168	(30,268)	0.8%	1.6%
5-yr. avg.	$ 678,863	$ 27,147	$ 3,263	$ 13,190	6.4%	7.2%

(1) Average of amounts at beginning and end of year.

(2) Investment income, net of investment expenses, including non-debt interest expense.

(3) Before income taxes.

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

Interest and General Corporate Expense

Interest expense on debt fell to $3.2 million in 2001, down from $5.3 million in 2000, which compared to $4.1 million in 1999. While some fluctuation in the amount of outstanding debt at interim occurred, the final balance in each of the last three years approximated $78.0 million, leaving the changes in interest expense almost entirely due to changes in the rate environment. General corporate expenses generally fluctuate relative to our executive compensation plan based on market value potential. This model basically measures comprehensive earnings against a minimum required return on our capital. These general corporate expenses were $2.6 million, $3.4 million and $2.1 million for 2001, 2000 and 1999, respectively.

Income Taxes

Our effective tax rates for 2001, 2000 and 1999 were 26.3%, 25.1% and 26.9%, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. Our pretax earnings in 2001 included $16.3 million of investment income that is wholly or partially exempt from federal income tax, compared to $16.3 million in 2000 and $15.7 million in 1999.

Investee Earnings

We maintain a 44% interest in the earnings of Maui Jim, Inc., primarily a manufacturer of high-quality polarized sunglasses. Maui Jim's Chief Executive Officer owns 56% of outstanding shares. Our investment in Maui Jim resulted from the 1996 merger of RLI Vision Corp., our ophthalmic business, and Maui Jim's parent company, Hester Enterprises, Inc. The resulting merged entity was named Maui Jim. In 2001, we recorded nearly $2.8 million in earnings compared to $3.0 million in

2000 and $1.6 million in 1999. Maui Jim net sales increased by 8%, despite the significant downturn in the worldwide economy. Net sales grew 32% in 2000 and 35% in 1999. Net sales from international operations grew by 42% in 2001. Gross margin continued to improve, with a 12% increase in 2001 and a 37% increase in 2000. Over the past two years, the strength of the dollar over the yen and euro has resulted in improved margins along with improvements on the mix of business. Operating expenses grew by 16% in 2001 as a result of opening foreign operations, developing the worldwide sales force and opening a significant number of new accounts. Operating expenses grew by 29% in 2000.

Market Risk Disclosure

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

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

Our primary risk exposures are to changes in interest rates and equity prices, as we had no foreign exchange risk and only one derivative, warrants related to a private equity investment currently valued at $3.3 million, as of December 31, 2001.

Interest Rate Risk

Our primary exposure to interest rate risk is through our fixed-income investment portfolio and outstanding short-term debt instruments. Modified duration analysis is used to measure the sensitivity of our fixed-income portfolio to changes in interest rates, providing a measure of price percentage volatility. We attempt to minimize interest rate risk by matching the duration of our assets to that of our liabilities. We limit the financial statement impact of changes in interest rates by designating a portion of our fixed-income holdings as held-to-maturity. As of December 31, 2001, we had classified 57% of our fixed-income securities portfolio as held-to-maturity. The balance of our fixed-income portfolio is classified as either available-for-sale or trading. See Note 2 to our audited consolidated financial statements.

Interest rate risk will also affect our income statement due to its impact on interest expense. Our debt obligations are short-term in nature, as we had no long-term debt outstanding as of December 31, 2001. As a result, we assume interest rate risk in our ability to refinance these short-term debt obligations. Any rise in interest rates will cause interest expense to increase if debt levels are maintained at current levels. We will continue to monitor this outstanding debt and may use operating cash flow, the available-for-sale portion of our fixed-income portfolio or proceeds from any potential issuance of additional capital, including proceeds from this offering, to pay it down all or in part as market conditions warrant.

Equity Price Risk

Equity price risk is the potential that we will incur economic loss due to the decline of common stock prices. Beta analysis is used to measure the sensitivity of our equity portfolio to changes in the value of the S&P 500 index (an index representative of the broad equity market). As measured from December 31, 1981 to December 31, 2001, our equity portfolio had a beta of 0.66 in comparison to the S&P 500. This low beta statistic reflects our long-term emphasis on maintaining a conservative, value oriented, dividend driven investment philosophy for our equity portfolio. Historically, dividend paying common stocks have demonstrated superior down market performance characteristics.

Additional risk management techniques include (1) restricting individual security weightings to no more than 5% of our equity portfolio's market value, and (2) reducing exposure to sector risk by limiting the market value that can be invested in any one particular industry sector to 25% of our equity portfolio.

Equity securities are classified as available-for-sale, with unrealized gains and losses excluded from net earnings but recorded as a component of comprehensive earnings and shareholders' equity, net of deferred income taxes.

Sensitivity Analysis

The tables on pages 29 and 30 detail information on the market risk exposure for our financial investments as of December 31, 2001. Listed on each table is market value at December 31, 2001 of our assets and the expected reduction in market value given the stated hypothetical events. This sensitivity analysis assumes the composition of our assets remains constant over the period being measured and also assumes interest rate changes are reflected uniformly across the yield curve. The analysis does not consider any action we would undertake in response to the various changes in market conditions. For purposes of this disclosure, market-risk-sensitive instruments are divided into two categories: instruments held for trading purposes and those held for nontrading purposes. The examples given are not predictions of future market events, but rather illustrations of the effect such events may have on the market value of our investment portfolio.

As of December 31, 2001, our fixed-income portfolio had a market value of $472.4 million. The sensitivity analysis uses scenarios of interest rates increasing 100 and 200 basis points from their December 31, 2001 levels, with all other variables held constant. Such scenarios would result in decreases in the market value of our fixed-income portfolio of $19.1 million and $38.0 million, respectively. Due to our use of the held-to-maturity designation for a majority of our fixed-income portfolio, the balance sheet impact of these scenarios would be much lower. The income statement will be affected only by holdings designated as trading. As of December 31, 2000, our fixed-income portfolio had a market value of $409.0 million. Given the same scenarios, the corresponding decreases in the market value of our fixed-income portfolio as of the end of 2000 were $15.7 million and $31.8 million, respectively. The potential decrease for 2001 is larger than for 2000, due to continuing purchases of fixed-income investments during 2001.

As of December 31, 2001, our equity portfolio had a market value of $277.6 million. The base sensitivity analysis uses market scenarios of the S&P 500 index declining both 10% and 20%. These scenarios would result in approximate decreases in the market value of our equity portfolio of $18.3 million and $36.6 million, respectively. As we designate all common stock holdings as available-for-sale, these market value declines would impact our balance sheet. As of December 31, 2000, our equity portfolio had a market value of $306.2 million. Given the same scenarios, the market value decreases as of the end of 2000 were $20.2 million and $40.4 million, respectively the change attributable to a decline in the equity portfolio during 2001.

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

The income statement will also be impacted by interest expense. As of December 31, 2001, we had $77.2 million in short-term debt obligations. Assuming this debt level remains constant, a hypothetical 100-basis-point increase in interest rates would increase our annual interest expense by $0.8 million and a 200-basis-point increase would increase annual interest expense by $1.5 million. Conversely, falling interest rates would result in equivalent reductions in interest expense. These numbers are not included in the following tables. As of December 31, 2000, we had $78.8 million of short-term debt outstanding.

Because the amount of debt outstanding remained fairly constant through the end of 2000, there would be a minimal change in the increases in interest expense over last year, given the stated scenarios.

Table 1
Effect of a 100-basis-point increase in interest rates and a 10% decline in the S&P 500:

	12/31/01 Market Value	Interest Rate Risk	Equity Risk
		(in thousands)	
Held for trading purposes:			
Fixed maturity securities	$ 7,568	$ (278)	
Total trading	7,568	(278)	
Held for nontrading purposes:			
Fixed maturity securities	464,870	(18,794)	
Equity securities	277,621		$ (18,323)
Total nontrading	742,491	(18,794)	(18,323)
Total trading & nontrading	$ 750,059	$ (19,072)	$ (18,323)

Table 2
Effect of a 200-basis-point increase in interest rates and a 20% decline in the S&P 500:

	12/31/01 Market Value	Interest Rate Risk	Equity Risk
	(in thousands)		
Held for trading purposes:			
Fixed maturity securities	$ 7,568	$ (543)	
Total trading	7,568	(543)	
Held for nontrading purposes:			
Fixed maturity securities	464,870	(37,473)	
Equity securities	277,621		$ (36,646)
Total nontrading	742,491	(37,473)	(36,646)
Total trading & nontrading	$ 750,059	$ (38,016)	$ (36,646)

Table 3

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

	12/31/01 Market Value	Interest Rate Risk	Equity Risk
	(in thousands)		
Held for trading purposes:			
Fixed maturity securities	$ 7,568	$ 279	
Total trading	7,568	279	
Held for nontrading purposes:			
Fixed maturity securities	464,870	18,598	
Equity securities	277,621		$ 18,323
Total nontrading	742,491	18,598	18,323
Total trading & nontrading	$ 750,059	$ 18,877	$ 18,323

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Table 4

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

	12/31/01 Market Value	Interest Rate Risk	Equity Risk
	(in thousands)		
Held for trading purposes:			
Fixed maturity securities	$ 7,568	$ 572	
Total trading	7,568	572	
Held for nontrading purposes:			

	12/31/01 Market Value	Interest Rate Risk	Equity Risk
Fixed maturity securities	464,870	37,887	
Equity securities	277,621		$ 36,646
Total nontrading	742,491	37,887	36,646
Total trading & nontrading	$ 750,059	$ 38,459	$ 36,646

Liquidity and Capital Resources

Historically, our primary sources of liquidity have been funds generated from insurance premiums and investment income (operating activities) and maturing investments (investing activities). In addition, we have occasionally received proceeds from financing activities such as the sale of common stock to the employee stock ownership plan, the sale of convertible debentures, and short-term borrowings. We continually monitor capital adequacy and surplus leverage, including the Group's statutory premiums to surplus ratio. Given the premium growth over the past twelve to twenty-four months, we are seeking to raise capital to support further premium growth.

Invested assets at September 30, 2002 increased by $74.0 million, or 9.3%, from December 31, 2001. Contributing to this increase was the investment of cash flows from operations, offset by unrealized losses on the investment portfolio totaling $49.1 million.

At September 30, 2002, we had short-term investments, cash and other investments maturing within one year, of approximately $127.8 million and additional investments of $133.3 million maturing within five years. We maintain one primary source of credit, a $40.0 million line of credit. The facility was recently expanded from a $30.0 million line and was renewed for a three-year period ending May 31, 2005. It is non-cancelable during its term. As of September 30, 2002, we had $40.0 million in outstanding short-term borrowings on this facility. Additionally, we were party to four reverse repurchase transactions totaling $47.4 million.

Our management believes that cash generated by operations, cash generated by investments and cash available from financing activities, including this offering, will provide sufficient sources of liquidity to meet our anticipated needs over the next twelve to twenty-four months.

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 dividend distribution is limited by Illinois law to the greater of 10% of RLI Insurance Company's policyholder surplus as of December 31 of the preceding year or its net income for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend distribution that can be paid by RLI Insurance Company during 2002 without prior approval is $29.0 million 10% of RLI Insurance Company's 2001 policyholder surplus. The actual amount paid to us thus far in 2002 is $5.3 million.

We continue an innovative catastrophe reinsurance and loss financing program with Zurich Insurance Company (ZIC). The program, called Catastrophe Equity Puts (CatEPuts^{SM}), augments our

traditional reinsurance by integrating our loss financing needs with a prenegotiated sale of securities linked to exchange-traded shares. For more detailed descriptions of CatEPuts, see Note 5 to our audited consolidated financial statements and "Business Reinsurance" beginning on page 40.

Our fixed-income portfolio continues to be biased toward U.S. government and government agency securities and highly rated corporate and tax-exempt securities due to their high liquidity. As part of our investment strategy, we attempt to avoid exposure to default risk by holding, almost exclusively, securities ranked in the top two grades of investment quality by Standard & Poor's and Moody's (i.e., AAA or AA). Virtually all of our fixed-income portfolio (98%) consists of securities rated A or better; 87% are rated AA or better. A greater allocation (from 1% to 12%) of A-rated corporate issues occurred during the year, consistent with the most attractive investment opportunities. The average quality of our fixed-income portfolio securities remains AAA-rated; most of the portfolio is noncallable.

We follow a program of matching assets to anticipated liabilities that are factored against ultimate payout patterns and the resulting payout streams are funded with the purchase of fixed-income securities of like maturity. We believe that both liquidity and interest rate risk can be minimized by such asset/liability matching.

We currently classify 43% of the securities in our fixed-income portfolio as held-to-maturity, meaning they are carried at amortized cost and are intended to be held until their contractual maturity. Smaller portions of our fixed-income portfolio are classified as available-for-sale (55%) or trading (2%) and are carried at fair market value. As of September 30, 2002, we maintained $318.3 million in fixed-income securities within the available-for-sale and trading classifications. The available-for-sale portfolio provides an additional source of liquidity and can be used to address potential future changes in our asset/liability structure.

In addition, at September 30, 2002 our equity portfolio had a value of $213.4 million, all of which is classified as available-for-sale and is also a source of liquidity. The securities within our equity portfolio remain primarily invested in large-capitalization issues with strong dividend performance. The strategy remains one of value investing, with security selection taking precedence over market timing. We use a buy-and-hold strategy to minimize both transaction costs and taxes.

Outlook for 2003

In 2003, it is anticipated that some of the catastrophic events of 2001 and 2002, such as the Enron collapse and the terrorist attacks of September 11, will continue the firming of the insurance market. During 2002, we have seen better quality risks at better rates, virtually across the board, and we expect this trend to continue. While the events of 2001 and 2002 also served to increase reinsurance costs on some product lines, we believe that increasing premium rates will serve to offset these higher costs. As always, we will continue our pursuit of growth through such avenues as the addition of underwriting talent in certain product lines or strategic alliances with producers on existing products or through acquisitions. The materiality or viability of future ventures or products is not known at this time. Specific details regarding events in our various business segments follow.

Casualty Segment

Continued growth is expected for this segment across virtually all product lines as the rate environment continues to develop very favorably. We continue to emphasize this marketplace as the combination of firming rates and superior submissions persists. While the combined ratio for this segment typically hovers near 100%, some expense efficiencies are anticipated relative to the considerable premium increases. Increased cash flows from this segment will contribute appreciably to the growth of investment income.

Property Segment

A return to more substantial growth in the property segment is expected as significant rate increases are continuing through the end of 2002. While last year was spent managing exposures on the segment's difference in conditions line, resulting in flat premium volume, 2002 writings reflect the rewards of this effort as rate increases take effect. Improved profitability is also anticipated as a combined result of rate increases on domestic fire and construction lines and aggressive underwriting actions taken on unprofitable lines during the year.

Surety Segment

Modest growth is projected for surety business, particularly in the contract bond line, pending the duration of the current economic downturn. Underwriting profits are expected to rise in 2002 because of tighter underwriting controls and an expected improving economy. Additionally, due to new accounting guidance on acquisitions, goodwill amortization will no longer be recognized beginning in 2002. This will be reflected in an improved expense ratio for the surety segment in 2002, relative to the acquisition of Underwriters Indemnity in 1999.

Capital Management

In July 1997, we implemented a 4.5 million share common stock repurchase program. In early 2001, we repurchased 5,544 shares at a total cost of $122,895. Approximately 560,000 shares remained authorized for repurchase at year-end 2001. We did not repurchase any of our outstanding shares during the first nine months of 2002. In December 2001, we reissued 194,250 treasury shares to fund benefit plans. Through September 30, 2002 we have reissued 18,746 treasury shares. It is anticipated that such funding will continue as capital requirements and market conditions warrant.

The repurchase program has been funded by the use of our operating cash flow, our revolving line of credit and reverse repurchase agreements. It is anticipated that any future repurchases will be funded in a similar fashion.

We paid a dividend of $0.09 per share on October 15, 2002. This was the second dividend increase in 2002 and the 105th consecutive dividend payment by us. Since we began paying cash dividends in 1976, we have increased our annual dividend every year. In its 2001 "Handbook of Dividend Achievers," Mergent FIS (formerly a division of Moody's) ranked us 176th out of more than 10,000 U.S. public companies in dividend growth over the last decade.

Accounting Standards

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133). SFAS 133 addresses the accounting for and disclosure of derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities. SFAS 133 standardizes the accounting for derivative instruments by requiring that an entity recognize those items as assets or liabilities in the statement of financial position and measure them at fair value. SFAS 133, as amended by SFAS 137 and 138, was effective for all fiscal quarters of fiscal years beginning after June 15, 2000.

In March 2001, the FASB adopted the guidance set forth in Derivatives Implementation Group (DIG) Issue A17, "Contracts That Provide for Net Share Settlement." Based on this guidance, we determined that stock warrants received in conjunction with the purchase of a note receivable qualify as derivatives under SFAS 133. Therefore, in accordance with the transition provisions of SFAS 133, we accounted for these warrants as derivatives effective April 1, 2001. The warrants were marked to fair value, as of April 1, 2001, with a cumulative-effect adjustment of $800,415, net of tax. The change in

fair value of this instrument from April 1 to September 30, 2001 totaled $1.0 million and was recorded through the statement of earnings as net investment income. During the first nine months of 2002, we recorded $1.6 million in net investment income to recognize the current period change in the fair value of these stock warrants.

In July 2001, the FASB issued SFAS 141 "Business Combinations," effective for all business combinations initiated after June 30, 2001, and SFAS 142 "Accounting for Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. We adopted the provisions of these statements. SFAS 141 requires the purchase method of accounting be used for all business combinations. Goodwill and indefinite lived intangible assets will remain on the balance sheet and not be amortized. Intangible assets with a definite life will continue to be amortized over their estimated useful lives. SFAS 142 establishes a new method of testing goodwill for impairment. On an annual basis, and when there is reason to suspect that their values may have been diminished or impaired, these assets must be tested for impairment. The amount of goodwill determined to be impaired will be expensed to current operations.

Amortization of intangible assets was $366,000 in the first nine months of 2002 compared to $1.6 million for the same period last year. This decrease is the result of no longer amortizing goodwill, subsequent to the adoption of SFAS 142. Intangible assets that continue to be amortized under SFAS 142 relate to our purchase of customer-related and marketing-related intangibles. These intangibles have useful lives ranging from 5 to 10 years. Amortization expense on the intangible assets is estimated to be $500,000 for each of the next five years. At September 30, 2002, net intangible assets totaled $2.0 million, net of $2.3 million of accumulated amortization, and are included in other assets. At December 31, 2001 net intangible assets totaled $2.4 million, net of $1.9 million of accumulated amortization.

Goodwill, which is no longer amortized, is broken out separately on the balance sheet and totals $28.9 million at September 30, 2002, compared to $28.5 million at December 31, 2001. During the first quarter of 2002, we paid $470,000 for increased ownership in an investment accounted for under the equity method. This payment was recorded as goodwill. Goodwill relates to our surety segment. Impairment testing was performed during the second quarter of 2002, pursuant to the requirements of SFAS 142. Based upon this valuation analysis, goodwill does not appear to be impaired. Impairment testing will continue to be performed on an annual basis, or when there is reason to suspect the value of these assets has diminished or is impaired. A reconciliation of the pro forma effects of eliminating the amortization of goodwill for the nine months ended September 30, 2001 and 2002, and for each of the years in the three-year period ended December 31, 2001 can be found on pages F-38 and F-39 of our interim consolidated financial statements.

In August 2001, the FASB issued SFAS 143, "Accounting for Asset Retirement Obligations," which becomes effective for fiscal years beginning after June 15, 2002. SFAS 143 addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs.

In October 2001, the FASB issued SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" and the accounting and reporting provisions of APB 30, "Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" for the disposal of a segment of a business. SFAS 144 retains many of the fundamental provisions of SFAS 121, but resolves certain implementation issues associated with that statement. SFAS 144 is effective for fiscal years beginning after December 15, 2001.

In April 2002, the FASB issued SFAS 145, "Rescission of FASB Statements No. 4, 44, 64, Amendment of FASB Statement 13, Technical Corrections." This statement will rescind FASB

Statements 4, 44, and 64, amend FASB Statement 13, and make certain technical corrections. The rescission of Statements 4 and 64 will affect income statement classification of gains and losses from extinguishment of debt. SFAS 145 is effective for financial statements issued on or after May 15, 2002.

In April 2002, the FASB issued SFAS 146, "Accounting For Costs Associated With Exit or Disposal Activities." This statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." Under SFAS 146, a commitment to an exit or disposal plan no longer will be a sufficient basis for recording a liability for those activities. SFAS 146 is effective for exit or disposal activities that are initiated after December 15, 2002.

The provisions of SFAS 143, 144, 145, and 146 are not anticipated to have a material impact on our consolidated financial statements.

Other Matters

We maintain a noncontributory defined pension plan covering substantially all employees meeting age and service requirements. We account for this plan pursuant to the requirements of SFAS 87, "Employers' Accounting for Pensions," and SFAS 106, "Employers Accounting for Postretirement Benefits Other Than Pensions." According to these statements, the measurement of net periodic pension cost for both interim and annual financial statements should be based on the assumptions used for the previous year-end measurements, unless a significant event occurs that would require an interim re-measurement. Our management believed that a 50-basis point drop in Aa corporate bond yields during the first nine months of 2002, coupled with a reduction in the fair value of plan assets constituted an event for which an interim review of plan assumptions was warranted. Previously, the following pension assumptions were used: 7.25% discount rate, 6% compensation increase, and 10% return on plan assets. As a result of the interim review, we began applying the following assumptions, prospectively, on July 1, 2002: 6.75% discount rate, 5% compensation increase, and 9% return on plan assets. The change to the discount rate was made to reflect the 50-basis point drop in Aa corporate yields since year-end. The rate of compensation increase is impacted by a number of factors, including the overall labor market, workforce demographics, and inflation. We believe that 5% provides a reasonable estimate, given the current environment. Our pension assets continue to be invested predominately in equity securities. Including the market's downward experience over the past two years, the inception-to-date annual return for the plan is 9.89%, through September 30, 2002. We believe 9% was a reasonable assumption to use going forward. The net impact on pension expense from the July 1, 2002 change in assumptions totaled $72,000 for the third quarter. Additionally in September 2002, we contributed $2.6 million in cash to the pension plan to maintain a current liability funded ratio of 100%.

BUSINESS

Company Overview

We conduct operations principally through four 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. Underwriters Indemnity Company, or UIC, a subsidiary of RLI Insurance Company, has authority to write multiple lines of insurance on an admitted basis in 33 states and the District of Columbia and surplus lines insurance in Ohio. Planet Indemnity Company, or PIC, a subsidiary of Mt. Hawley, has authority to write multiple lines insurance on an admitted basis in 47 states and the District of Columbia. PIC has authority to write surplus lines insurance in an additional three states. Other companies in our group include: Replacement Lens Inc., RLI Insurance Agency, Ltd., RLI Insurance Ltd., Underwriters Indemnity General Agency, Inc., and Safe Fleet Insurance Services, Inc.

As a "niche" company, we offer specialty insurance products designed to meet specific insurance needs of targeted insured groups. These targeted insured markets are often not served or are underserved by standard companies. Typically the development of these specialty insurance products is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients.

Since 1977, when we first began underwriting specialty property and casualty coverages for commercial risks, highly cyclical market conditions and a number of other factors have influenced our growth and underwriting profits. From 1987 to 2001, the industry experienced generally soft market conditions featuring intensified competition for admitted and surplus lines insurers, resulting in rate decreases. We continually monitored our rates and controlled our costs in an effort to maximize profits during this entrenched soft market condition. As a result of catastrophic losses, such as Hurricane Andrew and the Northridge Earthquake, in the mid-1990's, property rates hardened in California, Florida and the wind belt, but remained soft in other areas of the country. During this period, rates hardened and premium growth was achieved in the commercial property book of business. Otherwise, rates for property and casualty lines continued to decline over time. To maintain profitability, underwriters tightened selection criteria, broadened their focus to other market segments and gave up business where rates fell below our tolerance.

Since the end of 1999, a trend of modest price firming emerged in many of the markets in which we participate. Since early in 2001, a return to conservative underwriting has become common in the industry for the segments in which we write business. We believe that insurance companies, as a whole, have continued to be more conservative in their underwriting philosophy and will continue to be conservative in the near future. We believe that conservative underwriting will manifest itself in higher premium rates, more selectivity in risks insured and reduction in coverages. The events of September 11, 2001 and the reduction in available reinsurance capacity have opened up more demand for our specialty products. While we anticipate a steady growth in market share, we do not anticipate any increase that would warrant disclosure of a material impact. We expect the demand for specialty products to increase in the areas of primary casualty business, and directors and officers insurance, particularly as increased reinsurance costs limit new companies from entering these lines of business. We also expect that our personal umbrella policy will grow as we are one of the few insurers that write this coverage without also writing the underlying auto and homeowners insurance.

We initially wrote specialty property and casualty insurance through independent underwriting agents. We opened our first branch office in 1984, and began to shift from independent underwriting agents to wholly-owned branch offices which market to wholesale producers. We also market certain products to retail producers from several of our Casualty, Surety and Property Divisions. We produce a

limited amount of business under agreements with underwriting general agents under the auspices of our product vice presidents. The majority of business is marketed through our branch offices located in Los Angeles, California; Oakland, California; Glastonbury, Connecticut; Sarasota, Florida; Atlanta, Georgia; Alpharetta, Georgia; Honolulu, Hawaii; Chicago, Illinois; Peoria, Illinois; Boston, Massachusetts; St. Paul, Minnesota; Summit, New Jersey; Cleveland, Ohio; Philadelphia, Pennsylvania; Dallas, Texas; Houston, Texas; and Seattle, Washington.

For the nine months ended September 30, 2002, the following table provides the geographic distribution of our risks insured as represented by direct premiums earned for all product lines. For the nine months ended September 30, 2002, no other state accounted for more than 2% of total direct premiums earned for all product lines.

State	**Direct Premiums Earned**	**Percent of Total**
	(in thousands)	
California	$ 109,490	25.1%
Texas	47,259	10.8%
Florida	36,876	8.5%
New York	29,416	6.7%
Illinois	16,023	3.7%
Georgia	14,522	3.3%
Ohio	12,690	2.9%
Pennsylvania	12,675	2.9%
New Jersey	10,421	2.4%
Tennessee	9,134	2.1%
Hawaii	8,263	2.0%
Missouri	8,125	2.0%
All Other	120,903	27.6%
Total direct premiums	$ 435,797	100.0%

State	Direct Premiums Earned	Percent of Total

In the ordinary course of business, we rely on other insurance companies as business partners to share risks through reinsurance. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk, known as facultative placements. In addition, there are excess of loss and catastrophe reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. The arrangements provide greater diversification of business and serve to limit the maximum net loss on catastrophes and large and unusually hazardous risks. Reinsurance is subject to certain risks, specifically market risk, which affects the cost of, and the ability to secure, these contracts, and collection risk, which is the risk that our reinsurers may not pay on losses in a timely fashion or at all. The following table illustrates, through premium volume, the degree to which we utilize reinsurance. See Note 5 to our audited consolidated financial statements for an expanded discussion of the impact of reinsurance on our operations.

	9 months				
Written Premiums:	**2002**	**2001**	**2001**	**2000**	**1999**
			(in thousands)		
Direct	$ 534,815	$ 380,139	$ 511,985	$ 437,866	$ 339,575
Reinsurance ceded	(231,354)	(145,702)	(196,772)	(177,013)	(111,951)
Net	$ 303,461	$ 234,437	$ 315,213	$ 260,853	$ 227,624

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Specialty Insurance Market Overview

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

We operate in the excess and surplus market and the specialty admitted market.

Excess and Surplus Market

The excess and surplus market focuses on hard to place risks and risks that admitted insurers specifically refuse to write. Excess and surplus eligibility allows our insurance subsidiaries to underwrite nonstandard market risks with more flexible policy forms and unregulated premium rates. This typically results in coverages that are more restrictive and more expensive than in the standard admitted market. In 2001, the excess and surplus market represented approximately $15.7 billion, or 4.4%, of the entire $357 billion, domestic property and casualty industry, as measured by direct premiums written. For the nine months ended September 30, 2002, our excess and surplus units had direct premiums written of $212.1 million representing approximately 39.7% of our total direct written premium for the period.

Specialty Admitted Market

We also write business in the specialty admitted market. Most of these risks are unique and hard to place in the standard market, but for marketing and regulatory reasons, they must remain with an admitted insurance company. The specialty admitted market is subject to greater state regulation than the excess and surplus market, particularly with regard to rate and form filing requirements, restrictions on the ability to exit lines of business, premium tax payments and membership in various state associations, such as state guaranty funds and assigned risk plans. For the nine months ended September 30, 2002, our specialty admitted units had direct premiums written of $322.7 million representing approximately 60.3% of our total direct written premium for the period.

Business Overview

We presently underwrite selected property and casualty insurance across three distinct business segments: casualty, property and surety.

Casualty Segment

General Liability

Our general liability business consists primarily of coverage for third party liability of commercial insureds including manufacturers, contractors, apartments and mercantile risks. Net earned premiums totaled $47.7 million, $34.9 million and $31.1 million, or 15%, 13% and 14% of consolidated net revenues for the years 2001, 2000 and 1999, respectively. Net earned premiums totaled $52.1 million and $34.8 million, or 19% and 15% of consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Commercial and Personal Umbrella Liability

Our commercial umbrella coverage is principally written in excess of primary liability insurance provided by other carriers and, to a small degree, in excess of primary liability written by us. The personal umbrella coverage, which is produced through the Specialty Markets Division, is written in excess of the homeowners and automobile liability coverage provided by other carriers. Net earned premiums totaled $56.3 million, $62.9 million and $59.0 million, or 18%, 24% and 26% of consolidated net revenues for the years 2001, 2000 and 1999, respectively. Net earned premiums totaled $24.9 million and $42.2 million, or 9% and 19% of consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Executive Products

We produce financial products such as directors' and officers', or D&O, liability and other miscellaneous professional liability for a variety of low to moderate classes of risks. Recent events affecting the economy have resulted in several insurers discontinuing writing D&O coverage, and this has created an opportunity to raise rates significantly and reduce exposures. The package of coverages offered has been expanded to include a variety of coverages of interest to corporations and executives, such as employment practices liability and fiduciary liability. This is designed to give the product broader appeal. Net earned premiums totaled $4.5 million, $3.0 million and $2.6 million, or 1% of consolidated net revenues for the years 2001, 2000 and 1999, respectively. Net earned premiums totaled $5.9 million and $3.2 million, or 2% and 1% of consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Program Business

We began writing program business in 1998 through a broker in New Jersey. During 2001, we improved our infrastructure to streamline processing through automation and utilization of new technologies that shorten the time required to launch new products and programs. We continue to develop new programs for a variety of affinity groups. Coverages offered include: commercial property, general liability, commercial automobile, inland marine, and crime. Often, these coverages are combined into a package or portfolio policy. We have recently moved to a strategy of bringing all risk underwriting "in house" while continuing to rely upon program administrators for policy servicing and sales. Net earned premiums totaled $8.5 million, $4.6 million and $456,000 for 2001, 2000 and 1999, respectively. These amounts represent 3% of consolidated net revenues for 2001 and 2% of revenues in 2000. Net earned premiums totaled $17.5 million and $6.1 million, or 6% and 3% of consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Transportation

In 1997, we opened a transportation insurance facility in Atlanta to offer automobile liability and physical damage insurance to local, intermediate and long haul truckers, public transportation risks and equipment dealers. We also offer incidental, related insurance coverages, including general liability, commercial umbrella and excess liability, and motor truck cargo. The facility is staffed by highly experienced transportation underwriters who produce business through independent agents and brokers nationwide. Net earned premiums totaled $23.5 million, $14.2 million and $9.6 million, or 8%, 5% and 4% of consolidated net revenues for 2001, 2000 and 1999, respectively. Net earned premiums totaled $32.1 million and $16.2 million, or 12% and 7% of consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Other

We offer a variety of other smaller programs, including deductible buy-back, in-home business, and employer's excess indemnity. Net earned premiums from these lines totaled $16.4 million, $17.3 million and $15.6 million, or 5%, 7% and 6% of consolidated net revenues for the years 2001, 2000 and 1999, respectively. Net earned premiums from these lines totaled $12.8 million and $12.7 million, or 5% and 6% of consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Property Segment

Commercial Property

Our commercial property coverage consists primarily of excess and surplus lines and specialty insurance such as fire and "difference in conditions," which includes earthquake, wind, flood and collapse coverages written in the United States. We write coverage for a wide range of commercial and industrial risks such as office buildings, apartments, condominiums, certain industrial and mercantile structures, buildings under construction and movable equipment. We also write boiler and machinery coverage under the same management as commercial property. In 2001, 2000, and 1999, net earned premiums totaled $62.9 million, $51.8 million and $43.9 million, or 20%, 20% and 19%, respectively, of our consolidated net revenues. During the first nine months of 2002 and 2001, net earned premiums totaled $59.3 million and $46.1 million, or 22% and 20%, respectively, of our consolidated net revenues.

Homeowners/Residential Property

In 1997, we acquired a book of homeowners and dwelling fire business for Hawaii homeowners from the Hawaii Property Insurance Association. In the aftermath of Hurricane Iniki in 1992, this business was available at reasonable rates and terms. Net earned premiums totaled $7.9 million, $8.7 million and $6.9 million, or 3% of consolidated net revenues for 2001, 2000, and 1999, respectively. Net earned premiums totaled $5.3 million and $6.0 million, or 2% and 3% of our consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Other

We acquired property business as a part of our acquisition of Underwriters Indemnity Holdings on January 29, 1999. All property coverages associated with this business were non-renewed in accordance with allowed policy provisions. In 1999, net earned premiums totaled $622,000 or less than 1% of consolidated net revenue. In 2000, net earned premiums were negative ($485,000), as reinsurance adjustments resulted in a reclass between premium earned and ceded commissions. This change resulted in no net impact to our bottom line. No premiums were earned on this business in 2001 or 2002.

Surety Segment

Our surety business focuses on writing contract bonds for small size contractors, energy-related business for oil and gas operators and a wide range of commercial surety bonds through independent agencies, regional and national brokers. Additional contract surety business is underwritten on our behalf by Surety America, LLC, an independent underwriting agency of which we own 49%. Net earned premium totaled $45.3 million, $34.7 million, and $25.4 million, or 15%, 13% and 11% of consolidated net revenues for 2001, 2000 and 1999, respectively. Net earned premiums totaled $37.5 million and $32.5 million, or 14% of consolidated net revenues, for the first nine months of 2002 and 2001, respectively.

Competition

Our specialty property and casualty insurance subsidiaries are part of an extremely competitive industry that is cyclical and historically characterized by periods of high premium rates and shortages of underwriting capacity followed by periods of severe competition and excess underwriting capacity. Within the United States alone, approximately 2,500 companies, both stock and mutual, actively market property and casualty products. Our primary competitors in our casualty segment include ACE, AIG, Great West Casualty, Berkshire Hathaway Insurance Group and others. Our primary competitors in our property segment include AIG, Markel Group, St. Paul Companies and others. Our primary competitors in our surety segment include Chubb Group, CNA Insurance Companies and St. Paul Companies. The combination of products, service, pricing and other methods of competition vary from line to line. Our principal methods of meeting this competition are innovative products, marketing structure and quality service to the agents and policyholders at a fair price. We compete favorably in part because of our sound financial base and reputation, as well as our broad geographic penetration into all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. In the property and casualty area, we have acquired experienced underwriting specialists in our branch and home offices. We have continued to maintain our underwriting and marketing standards by not seeking market share at the expense of earnings. New products and new programs are offered where the opportunity exists to provide needed insurance coverage with exceptional service on a profitable basis.

Ratings

A.M. Best ratings for the industry range from "A++" (Superior) to "F" (In Liquidation) with some companies not being rated. Standard & Poor's ratings for the industry range from "AAA" (Superior) to "CC" (Default Expected). Publications of both A.M. Best and Standard & Poor's indicate that "A" and "A+" ratings are assigned to those companies that, in their opinion, have achieved excellent overall performance when compared to the standards established by these firms and have a strong ability to meet their obligations to policyholders over a long period of time. In evaluating a company's financial and operating performance, both firms review the company's profitability, leverage and liquidity, as well as the company's spread of risk, the quality and appropriateness of its reinsurance, the quality and diversification of its assets, the adequacy of its policy and loss reserves, the adequacy of its surplus, its capital structure and the experience and objectives of its management. These ratings are based on factors relevant to policyholders, agents, insurance brokers and intermediaries and are not directed to the protection of investors.

During 2001, A.M. Best gave a group rating to the combined entity of both RLI Insurance Company and Mt. Hawley Insurance Company based on the similarities of management structure and strategy for the two firms. In 2002, the rating for the two companies was reaffirmed as "A", and both companies were assigned a financial size category of "IX". UIC's A.M. Best rating for 2002 remained "A-" (Excellent). PIC's A.M. Best rating for 2002 remained "A-" (Excellent). In 2001, Standard & Poor's reaffirmed our "A+" rating, citing our strong operating performance, capitalization and risk management. However, the outlook for the rating was revised to "Negative" as a result of continued catastrophe exposure in our difference in conditions product line.

As of December 31, 2001, we had no public debt outstanding; therefore, no debt rating existed.

Reinsurance

We reinsure a significant portion of our property and casualty insurance exposure, paying to the reinsurer a portion of the premiums received on such policies. Earned premiums ceded to non-affiliated reinsurers totaled $194.2 million through the first nine months of 2002 and $194.3 million and $161.5 million in 2001 and 2000, respectively. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. Although reinsurance does not legally

discharge an insurer from its primary liability for the full amount of the policies, it does make the assuming reinsurer liable to the insurer to the extent of the insurance ceded.

We attempt to purchase reinsurance from a number of financially strong reinsurers. Retention levels are adjusted each year to maintain a balance between the growth in surplus and the cost of reinsurance. Of our top 10 largest reinsurers (listed below), four are rated by A.M. Best Company as "A++, Superior" (American Re, General Cologne Re, Transatlantic and Swiss Re), four are listed as "A+, Superior" (Employers Re, Liberty Mutual, Everest Re and Toa-Re), St. Paul Ltd. is rated "A, Excellent," and Folksamerica Reinsurance Co. is rated "A-, Excellent." All other reinsurance balances recoverable, when considered by individual reinsurer, are less than 5% of shareholders' equity.

The following table sets forth the largest reinsurers in terms of amounts recoverable before reinsurance payables from such reinsurers as of September 30, 2002. Also shown are the amounts of written premium ceded by us to such reinsurers during the first nine months of 2002.

	Gross Reinsurer Exposure as of September 30, 2002	Percent of Total	Ceded Premiums Written	Percent of Total
	(in thousands)		(in thousands)	
American Re-Insurance Co.	$ 103,518	22.4%	$ 39,406	17.0%
Employers Reinsurance Corp.	63,107	13.7	33,582	14.5
General Cologne Re	52,313	11.3	25,511	11.0
Liberty Mutual Insurance Co.	16,778	3.6	10,232	4.4
Transatlantic Reinsurance	14,772	3.2	2,131	1.0
Everest Reinsurance Co.	13,342	2.9	9,085	3.9

	Gross Reinsurer Exposure as of September 30, 2002	Percent of Total	Ceded Premiums Written	Percent of Total
Toa-Re Insurance Co.	11,356	2.5	6,257	2.7
Swiss Reinsurance America	11,326	2.4	5,700	2.5
St. Paul Reinsurance Co.	11,104	2.4	2,993	1.3
Folksamerica Reinsurance Co.	10,456	2.3	4,121	1.8
All other reinsurers	154,029	33.3	92,340	39.9
Total ceded exposure	$ 462,101	100.0%	$ 231,358	100.0%

As of September 30, 2002, we held $6.5 million in irrevocable letters of credit, $7.8 million under trust agreements and $1.0 million in cash to collateralize a portion of the total amount recoverable.

Reinsurance is subject to certain risks, specifically market risk, which affects the cost of and the ability to secure reinsurance contracts, and collection risk, which relates to the ability to collect from the reinsurer on our claims. Since 1992, we have purchased non-proportional reinsurance contracts. This allows us to retain a larger percentage of the premium and a larger portion of the initial loss risk. Under non-proportional reinsurance, the ceding company retains losses on a risk up to a specified amount and the reinsurers assume any losses above that amount. Through our various reinsurance programs, we have generally limited our maximum retained exposure on any one risk to $2 million.

In 2002 and 2001, our underwriting was supported by up to $250.0 million in traditional catastrophe reinsurance protection. We continuously monitor and quantify our exposure to earthquake risk, the most significant catastrophe exposure to us, by means of catastrophe exposure models developed by independent experts in that field. For the application of the catastrophe exposure models, exposure and coverage detail is recorded at each risk location. The model results are used both in the underwriting analysis of individual risks, and at a corporate level for the aggregate book of catastrophe exposed business. From both perspectives, we consider the potential loss produced by events with a Richter magnitude (a measure of the energy released by an earthquake event) equivalent to the earthquake on those faults which represent the greatest loss potential to us, which are expected to recur at average intervals of 100 years, or 6.5 magnitude, whichever is greater. Under our models, the

probability that an earthquake event would exceed our reinsurance cover (including facultative, excess of loss, surplus, and cat treaty) was 0.71% as of December 31, 2001. In addition, we examine the portfolio exposure considering all possible earthquake events of all magnitudes and return periods, on all faults represented in the model. Under our models, the probability that an earthquake event would exceed our reinsurance cover and 100% of our surplus was 0.39% as of December 31, 2001.

In 2002, we continued our innovative catastrophe reinsurance and loss financing program with Zurich Insurance Company. The program, called Catastrophe Equity Puts (CatEPuts), augments our traditional reinsurance by allowing us to put up to $50.0 million of convertible preferred shares to Zurich at $1,000 per share in the event of a catastrophic loss, provided the loss does not reduce GAAP equity to less than $55.0 million. The preferred shares are convertible to common stock at the current market rate. CatEPuts began as a multi-year program and is designed to enable us to continue operating after a loss of such magnitude that our reinsurance capacity is exhausted. If we exercise our option to put preferred shares to Zurich, then Zurich, in turn, has the option to reinsure certain business written by us on a prospective basis. We have the option to repurchase the preferred shares in a three- to four-year period after issuance. In November 2000, we renewed this agreement for an additional three-year period. The annual commitment fee is recognized as a decrease in shareholders' equity.

Factors Affecting Specialty Property and Casualty Profitability

The profitability of the specialty property and casualty insurance business is generally subject to many factors, including rate adequacy, the severity and frequency of claims, natural disasters, state regulation, default of reinsurers, interest rates, general economic conditions and court decisions that define and expand the extent of coverage and the amount of compensation due for injuries or losses. One of the distinguishing features of the property and casualty insurance business is that its product must be priced before the ultimate claims costs can be known. In addition, underwriting profitability has tended to fluctuate over cycles of several years' duration. Insurers generally had profitable underwriting results in the late 1970s, substantial underwriting losses in the early 1980s and somewhat smaller underwriting losses in 1986 and 1987. During the years 1988 through 1992, underwriting losses increased due to increased rate competition and the frequency and severity of catastrophic losses, although pre-tax operating income remained profitable due to investment income gains. Since 1993, the industry experienced improvement in underwriting losses, particularly in years with fewer catastrophe losses. The trends experienced during the late 1980s, however, have continued and companies continue to post underwriting losses but remain profitable through investment income gains. For 2001, the industry's statutory combined ratio was 115.9, representing the worst performance for the property and casualty industry ever. Poor underwriting and investment losses both contributed to the results. For 2002, the industry is expected to improve to a 108.1 statutory combined ratio. We believe that certain other factors affect our ability to underwrite specialty lines successfully, including the following:

Specialized Underwriting Expertise

We employ experienced professionals in our underwriting offices. Each office restricts its production and underwriting of business to certain classes of insurance reflecting the particular areas of expertise of its key underwriters. In accepting risks, all independent and affiliated underwriters are required to comply with risk parameters, retention limits and rates prescribed by our underwriting group, which reviews submissions and periodically audits and monitors underwriting files and reports on losses over $100,000. Compensation of senior underwriters is substantially dependent on the profitability of the business for which they are responsible. The loss of any of these professionals could have an adverse effect on our underwriting abilities and earnings in these lines.

Retention Limits

We limit our net retention of single and aggregate risks through the purchase of reinsurance (see "Business Reinsurance"). The amount of reinsurance available fluctuates according to market conditions. Reinsurance arrangements are subject to annual renewal. Any significant reduction in the availability of reinsurance or increase in the cost of reinsurance could adversely affect our ability to insure specialty property and casualty risks at current levels or to add to the amount thereof.

Claims Adjustment Ability

We have a professional claims management team with proven experience in all areas of multi-line claims work. This team supervises the handling and resolution of all claims and directs all outside legal and adjustment specialists on an individual claim and/or audit basis. Whether a claim is being handled by our claim specialist or has been assigned to a local attorney or adjuster, detailed attention is given to each claim to minimize loss expenses while providing for loss payments in a fair and equitable manner.

Expense Control

Our management continues to review all areas of our operations to streamline the organization, emphasizing quality and customer service, while minimizing expenses. These strategies will help to contain the growth of future costs. Maintaining and improving underwriting and other key organizational systems continues to be paramount as a means of supporting our growth. We maintain a philosophy of acquiring and retaining talented insurance professionals and building infrastructure to support continued growth. Other insurance operating expenses totaled 4% of gross written premiums for the years 2001, 2000 and 1999. Through September 30, 2002, other insurance operating expenses totaled 3% of gross written premium compared to 4% for the same period last year.

Marketing and Distribution

Broker Business

The largest volume of broker generated premium is commercial property, general liability, commercial surety, commercial umbrella and commercial automobile. This business is produced through wholesale and retail brokers who are not affiliated with us.

Independent Agent Business

Our Surety Division offers its business through a variety of independent agents. Additionally, we write program business, such as personal umbrella and the in-home business policy, through independent agents. Homeowners and dwelling fire is produced through independent agents in Hawaii. Each of these programs involves detailed eligibility criteria, which are incorporated into strict underwriting guidelines. The programs involve prequalification of each risk using a system accessible by the independent agent. The independent agent cannot bind the risk unless they receive approval through our system.

Underwriting Agents

We contract with certain underwriting agencies who have limited authority to underwrite business on our behalf. These underwriting general agencies may receive some compensation through contingent profit commission. Otherwise, producers of business who are not our employees are generally compensated on the basis of direct commissions with no provision for any contingent profit commission.

E-commerce

We are actively employing e-commerce to produce and efficiently process and service business, including package policies for limited service motel/hotel operations and in-home businesses, small commercial and personal umbrella risks, liability insurance for artisan contractors and private investigators, California difference in conditions and New Madrid earthquake property coverages and surety bonding.

Environmental Exposures

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

The following table represents inception-to-date paid and unpaid environmental claims data (including incurred but not reported losses) for the periods ended 2001, 2000 and 1999:

	December 31,		
Inception-to-date	**2001**	**2000**	**1999**
		(in thousands)	
Loss and Loss Adjustment Expense (LAE) payments:			
Gross	$ 26,540	$ 23,720	$ 22,565
Ceded	(15,465)	(14,070)	(13,671)
Net	$ 11,075	$ 9,650	$ 8,894
Unpaid losses and LAE at end of year:			
Gross	$ 18,779	$ 17,110	$ 16,125
Ceded	(9,425)	(9,220)	(8,566)
Net	$ 9,354	$ 7,890	$ 7,559

Although our environmental exposure is limited as a result of entering liability lines after the industry had already recognized it as a problem, the ultimate liability for this category of exposure is difficult to assess because of the extensive and complicated litigation involved in the settlement of claims and evolving legislation on such issues as joint and several liability, retroactive liability and standards of cleanup. Additionally, we participate primarily in the excess layers, making it even more difficult to assess the ultimate impact.

Losses and Settlement Expenses

Many years may elapse between the occurrence of an insured loss, the reporting of the loss to the insurer and the insurer's payment of that loss. To recognize liabilities for unpaid losses, insurers establish reserves, which are balance sheet liabilities. The reserves represent estimates of future amounts needed to pay claims and related expenses with respect to insured events that have occurred.

When a claim is reported, our claim department establishes a "case reserve" for the estimated amount of the ultimate payment within 90 days of the receipt of the claim. The estimate reflects the informed judgment of professional claim personnel, based on our reserving practices and the experience and knowledge of such personnel regarding the nature and value of the specific type of claim. Estimates for losses incurred but not yet reported are determined on the basis of statistical information, including our past experience. We do not use discounting (recognition of the time value of money) in reporting our estimated reserves for losses and settlement expenses.

The reserves are closely monitored and reviewed by our management, with changes reflected as a component of earnings in the current accounting period. For lines of business without sufficiently large numbers of policies or that have not accumulated sufficient development statistics, industry average development patterns are used. To the extent that the industry average development experience improves or deteriorates, we adjust prior accident years' reserves for the change in development patterns. Additionally, there may be future adjustments to reserves should our actual experience prove to be better or worse than industry averages.

As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors, such as legal developments and economic conditions, including the effects of inflation. The reserving process provides implicit recognition of the impact of inflation and other factors affecting claims payments by taking into account changes in historic payment patterns and perceived probable trends. Changes in reserves from the prior years' estimates are calculated based on experience as of the end of each succeeding year (loss and settlement expense development). The estimate is increased or decreased as more information becomes known about the frequency and severity of losses for individual years. A redundancy means the original estimate was higher than the current estimate; a deficiency means that the current estimate is higher than the original estimate.

Due to the inherent uncertainty in estimating reserves for losses and settlement expenses, there can be no assurance that the ultimate liability will not exceed amounts reserved, with a resulting adverse effect on us. Based on the current assumptions used in calculating reserves, management believes our overall reserve levels at September 30, 2002 are adequate to meet our future obligations.

The table which follows is a reconciliation of our unpaid losses and settlement expenses for the nine months ended September 30, 2002 and September 30, 2001 and for the years 2001, 2000 and 1999.

	As of and for the nine months ended September 30,		December 31,		
	2002	2001	2001	2000	1999
			(Dollars in thousands)		
Unpaid losses and settlement expenses at beginning of year:					
Gross	$ 604,505	$ 539,750	$ 539,750	$ 520,494	$ 415,523
Ceded	(277,255)	(239,696)	(239,696)	(245,580)	(168,261)
Net	327,250	300,054	300,054	274,914	247,262
Unpaid losses and settlement expenses:					
UIH, Inc. Acquisition Date:					
Gross					74,979
Ceded					(67,642)
Net					7,337
Increase (decrease) in incurred losses and settlement expenses:					
Current accident year	138,824	111,587	146,909	126,220	101,053
Prior accident years	5,639	2,951	8,967	(1,634)	(4,596)
Total incurred	144,463	114,538	155,876	124,586	96,457
Losses and settlement expense payments for claims incurred:					
Current accident year	(23,997)	(22,662)	(35,738)	(34,373)	(21,675)
Prior accident years	(75,066)	(72,100)	(92,788)	(65,216)	(53,892)

	As of and for the nine months ended September 30,		December 31,		
Total paid	(99,063)	(94,762)	(128,526)	(99,589)	(75,567)
Insolvent reinsurer charged off (recovered)	(994)	148	(242)	143	(1,000)
Loss reserves commuted	0	0	88	0	425
Unpaid losses and settlement expenses at end of year:	$ 371,656	$ 319,978	$ 327,250	$ 300,054	$ 274,914
Unpaid losses and settlement expenses at end of year:					
Gross	$ 704,334	$ 551,569	$ 604,505	$ 539,750	$ 520,494
Ceded	(332,678)	(231,591)	(277,255)	(239,696)	(245,580)
Net	$ 371,656	$ 319,978	$ 327,250	$ 300,054	$ 274,914

An explanation of significant components of reserve development by calendar year is as follows:

1999. During 1999, we experienced $4.6 million of favorable development on loss reserves. This development resulted from approximately $4.3 million of favorable development in the property lines of business and approximately $708,000 of favorable development in the casualty lines of business. The favorable property development was a continuing result of the Northridge Earthquake claims from the 1994 accident year settling for less than the open reserves. Favorable development on casualty claims resulted from claim settlements and reevaluations of case reserves during the accounting period which were, in the aggregate, less than the IBNR and case reserves established at the beginning of the period.

2000. During 2000, we experienced $1.6 million of favorable development on loss reserves. This development was primarily the net result of reserve adjustments to our casualty segment. Indicated favorable loss experience on prior accident years resulted in a release of reserve redundancies.

2001. During 2001, we experienced $9.0 million of adverse development on loss reserves. Of this total, approximately $3.1 million of development occurred in the property segment. Property development related primarily to slower reporting of losses on international and certain other property lines written in 1999 and 2000. While it was decided to discontinue writing this business in 2000, higher than expected losses were experienced in 2001. The surety segment experienced $2.8 million in adverse development, primarily in the contract bond sector. Contract surety experienced losses beyond expectations, due in part, to the economic slowdown that occurred over the past year. Additionally, the casualty segment experienced $3.1 million in adverse development, primarily in the commercial umbrella book, where growth in coverage in commercial "long-haul" transportation business written in 1999 and 2000 resulted in losses that exceeded our traditional commercial umbrella development patterns. This impact was recognized during 2001 and we no longer write this class of business.

2002. Through September 30, 2002, we experienced approximately $5.6 million of adverse development on prior loss reserves. $3.2 million is attributable to the surety segment where economic factors continued to cause deterioration in the contract portion of this business. The remaining amount is the aggregate of a number of small, individually immaterial amounts from various discontinued classes of business. Due to the small volume of business written, these lines lacked sufficient experience data to accurately set reserves.

The table on the following page presents the development under accounting principles generally accepted in the United States of America (GAAP) of our balance sheet reserves from 1992 through 2001. The top line of the table shows the reserves at the balance sheet date for each of the indicated periods. This represents the estimated amount of losses and settlement expenses arising in all prior years that are unpaid at the balance sheet date, including losses that had been incurred but not yet reported to us. The lower portion of the table shows the re-estimated amount of the previously recorded reserves based on experience as of the end of each succeeding year. The estimate changes as more information becomes known about the frequency and severity of claims for individual periods.

	Year Ended December 31									
	1992 & Prior	1993	1994	1995	1996	1997	1998	1999	2000	2001
	(Dollars in thousands)									
Net Liability for unpaid losses and Settlement expenses at end of year	$ 140,248	$ 175,491	$ 204,771	$ 232,308	$ 247,806	$ 248,552	$ 247,262	$ 274,914	$ 300,054	$ 327,250
Paid (cumulative) as of:										
One year later	24,589	36,416	46,905	37,505	47,999	54,927	53,892	65,216	92,788	
Two years later	46,342	63,675	73,972	75,485	85,342	98,188	88,567	113,693		
Three years later	64,364	84,614	100,936	103,482	112,083	120,994	114,465			
Four years later	78,994	96,741	121,834	121,312	129,846	136,896				
Five years later	85,746	106,631	135,524	132,045	139,006					
Six years later	92,689	114,777	143,377	137,729						
Seven years later	97,164	120,760	146,333							
Eight years later	101,254	122,409								
Nine years later	102,748									
Liability re-estimated as of:										
One year later	128,600	166,666	218,499	220,185	240,264	245,150	243,270	273,230	309,021	
Two years later	132,850	164,218	214,352	228,636	242,865	248,762	233,041	263,122		
Three years later	132,376	157,286	212,964	222,761	233,084	232,774	229,750			
Four years later	127,426	168,782	217,790	210,876	219,888	220,128				
Five years later	140,536	163,127	207,355	202,596	207,148					
Six years later	134,950	156,210	199,632	191,805						
Seven years later	127,738	150,381	190,646							
Eight years later	123,395	143,353								
Nine years later	119,403									
Net cumulative redundancy (deficiency)	$ 20,845	$ 32,138	$ 14,125	$ 40,503	$ 40,658	$ 28,424	$ 17,512	$ 11,792	$ (8,967)	
Gross Liability		$ 310,767	$ 394,966	$ 418,986	$ 405,801	$ 404,263	$ 415,523	$ 520,494	$ 539,750	$ 604,505
Reinsurance (recoverable)		(135,276)	(190,195)	(186,678)	(157,995)	(155,711)	(168,261)	(245,580)	(239,696)	(277,255)
Net Liability		$ 175,491	$ 204,771	$ 232,308	$ 247,806	$ 248,552	$ 247,262	$ 274,914	$ 300,054	$ 327,250
Gross re-estimated liability			$ 397,275	$ 372,475	$ 356,386	$ 420,918	$ 483,697	$ 501,939	$ 619,344	
Re-estimated recoverable			(206,629)	(180,670)	(149,238)	(200,790)	(253,947)	(238,817)	(310,323)	
Net re-estimated liability			$ 190,646	$ 191,805	$ 207,148	$ 220,128	$ 229,750	$ 263,122	$ 309,021	
Gross cumulative redundancy (deficiency)			$ (2,309)	$ 46,511	$ 49,415	$ (16,655)	$ (68,174)	$ 18,555	$ (79,594)	

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Operating Ratios

Premiums to Surplus Ratio

The following table shows, for the periods indicated, our insurance subsidiaries' statutory ratios of net premiums written to policyholders' surplus. While there is no statutory requirement applicable to us that establishes a permissible net premiums written to surplus ratio, guidelines established by the National Association of Insurance Commissioners, or NAIC, provide that this ratio should generally be no greater than 3 to 1.

	As of and for the nine months ended September 30		Year Ended December 31,				
	2002	2001	2001	2000	1999	1998	1997
	(Dollars in thousands)						
Statutory net premiums written	$ 303,461	$ 234,437	$ 315,213	$ 260,853	$ 227,624	$ 145,701	$ 144,674
Policyholders' surplus	300,193	263,586	289,997	309,945	286,247	314,484	265,526
Ratio	1.3 to 1(1)	1.2 to 1(1)	1.1 to 1	.8 to 1	.8 to 1	.5 to 1	.5 to 1

(1) Computed on an annualized basis.

GAAP and Statutory Combined Ratios

Our underwriting experience is best indicated by our GAAP combined ratio, which is the sum of (a) the ratio of incurred losses and settlement expenses to net premiums earned (loss ratio) and (b) the ratio of policy acquisition costs and other operating expenses to net premiums earned (expense ratio).

	As of and for the nine months ended September 30		Year Ended December 31,				
GAAP	**2002**	**2001**	**2001**	**2000**	**1999**	**1998**	**1997**
Loss ratio	58.4	57.3	57.1	53.8	49.4	45.4	43.2
Expense ratio	37.7	40.1	40.1	41.0	41.8	42.8	43.6
Combined ratio	96.1	97.4	97.2	94.8	91.2	88.2	86.8

We also calculate the statutory combined ratio, which is not indicative of GAAP underwriting profits due to accounting for policy acquisition costs differently for statutory accounting purposes compared to GAAP. The statutory combined ratio is the sum of (a) the ratio of statutory loss and settlement expenses incurred to statutory net premiums earned (loss ratio) and (b) the ratio of statutory policy acquisition costs and other underwriting expenses to statutory net premiums written.

	As of and for the nine months ended September 30		Year Ended December 31,				
Statutory	**2002**	**2001**	**2001**	**2000**	**1999**	**1998**	**1997**
Loss ratio	58.0	57.4	57.1	53.8	47.6(2)	48.0	43.0
Expense ratio	33.8	39.5	38.7	42.0	42.5(2)	40.4	47.4
Combined ratio	91.8	96.9	95.8	95.8	90.1(2)	88.4	90.4
Industry combined ratio			115.9(1)	110.1(1)	107.8(1)	105.6(1)	101.6(1)

(1)
Source: A.M. Best Aggregate & Averages Property-Casualty (2002 Edition), statutory basis.

(2)
The ratios presented include the results of UIC and PIC only from the date of acquisition, January 29, 1999.

Investments

Oversight of our investment portfolios is conducted by an investment committee of our board of directors. We follow an investment policy that is reviewed quarterly and revised periodically.

Our investment portfolio serves primarily as the funding source for loss reserves and secondly as a source of income and appreciation. For these reasons, our primary investment criteria are quality and liquidity, followed by yield and potential for appreciation. Investments of the highest quality and marketability are critical for preserving our claims-paying ability. The majority of our fixed income investments are U.S. Government or AA-rated or better taxable and tax-exempt securities. Common stock investments are limited to securities listed on the national exchanges and rated by the Securities Valuation Office of the NAIC. With the exception of a small warrant position in a private equity investment, our portfolio contains no derivatives or off-balance sheet structured investments. In addition, we employ stringent diversification rules and balance our investment credit risk and related underwriting risks to minimize total potential exposure to any one security. Despite its low volatility, our overall portfolio's fairly conservative approach has contributed significantly to our historic growth in book value.

During 2001, we allocated the majority of our operating and portfolio cash flows to the purchase of intermediate-term corporate securities. The mix of instruments within the portfolio is decided at the time of purchase on the basis of available after-tax returns and overall taxability of all invested assets. Almost all securities reviewed for purchase are either high grade corporate, municipal or U.S. Government or agency debt instruments. As part of our investment philosophy, we attempt to avoid exposure to default risk by holding, almost exclusively, instruments ranked in the top three grades of investment security quality by Standard & Poor's and Moody's (i.e. AAA, AA, and A). As of September 30, 2002, 98% of the fixed income portfolio was rated A or better and 87% was rated AA or better. We limit interest rate risk by restricting and managing acceptable call provisions among new security purchases.

As of December 31, 2001, the municipal bond component of the fixed income portfolio decreased $1.1 million, to $195.6 million and comprised 42.3% of our total fixed income portfolio, down 6.7% from year-end 2000. The taxable U.S. Government and agency portion of the fixed income portfolio decreased by $45.4 million to $155.7 million, or 33.7% of the total versus 50.0% at year-end 2000. Investment grade corporate securities totaled $111.0 million compared to $4.0 million at year-end 2000 and comprised 24.0% of our total fixed income portfolio versus 1.0% at year-end 2000.

On September 30, 2002, our municipal bond holdings totaled $228.1 million or 40.8% of our total fixed income portfolio, an increase of $32.5 million over year-end 2001 levels. The taxable U.S. Government and agency portion of the portfolio increased by $30.3 million to $186.0 million or 33.3% of the total fixed income portfolio. Investment grade corporate securities totaled $144.3 million, an increase of $33.3 million from year end 2001, and comprised 25.9% of our total fixed income portfolio.

We follow a program of matching assets to anticipated liabilities to ensure our ability to hold securities until maturity. These anticipated liabilities are then factored against ultimate payout patterns and the resulting payout streams are funded with the purchase of fixed-income securities of like maturity. Our management believes that both liquidity and interest rate risk can best be minimized by such asset/liability matching.

Aggregate maturities for the fixed maturity securities are as follows:

Maturity Year	Par Value	Amortized Cost	Fair Value	Carrying Value
		(in thousands)		

Maturity Year	Par Value	Amortized Cost	Fair Value	Carrying Value
2003	$ 32,025,000	$ 32,040,386	$ 32,700,554	$ 32,064,179
2004	17,010,000	17,102,455	17,890,846	17,148,710
2005	31,025,000	31,179,896	33,198,878	31,341,478
2006	35,400,000	35,452,557	37,921,072	36,303,259
2007	46,795,000	47,006,836	51,368,646	48,479,180
2008	36,905,000	37,293,262	40,267,727	38,722,850
2009	78,720,000	78,524,647	84,640,540	81,208,395
2010				