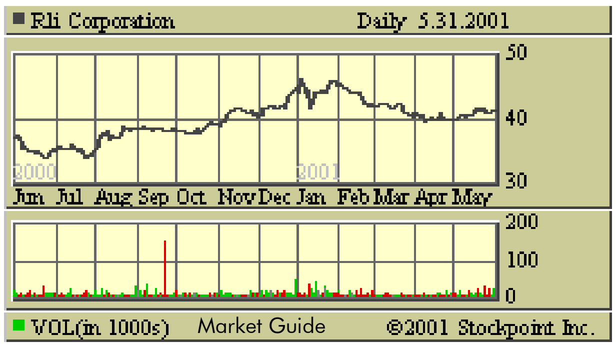
Specialty insurance products



RLI Corp.
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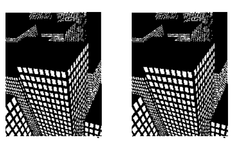

WSCR #103890
JONATHAN E. MICHAEL
President and
Chief Executive Officer

Interview by John O'Hanlon
Publisher and Managing Editor

Mr. Jonathan E. Michael

I began my career in the mid-70s with Coopers and Lybrand as a CPA where I audited insurance companies. I joined RLI Corp. in 1982 and have had increasing levels of responsibility over the years including controller, vice president of finance and chief financial officer. I then became executive vice president and was responsible for running the company's insurance operations for several years before becoming chief operating officer. I had been the COO of RLI since 1994 and it was a natural progression for me to move from that job to the position of president and chief executive officer of RLI Corp."

RLI
Fundamentally Innovative

RLI Corp

"RLI Corp., through its subsidiaries, RLI Insurance Company, Mt. Hawley Insurance Company, Underwriters Indemnity Company and Planet Indemnity Company, underwrites selected property and casualty insurance products. We are a company that underwrites business for profit. For the most part, we operate in all 50 states, do some business in the Caribbean and have dabbled internationally in a small way. That said, for the most part, we are a U.S.-based 50-state insurance holding company.

"RLI offers specialty insurance products that standard insurance markets will not write, except in a very soft market. Our products range from a $250 - premium personal umbrella policy to a $2 million premium commercial trucking policy that typically requires a great deal of underwriting and claims talent to handle. Therefore, one of our top core values as a company is to hire the absolute best talent in the industry to run our product lines and man our underwriting workstations. RLI is known for delivering exceptional customer service and that is a reputation we protect fiercely."

Types of insurance

"Ninety to 95% of our business is commercial insurance. In Hawaii, we offer homeowner's insurance and, through independent insurance agents, we offer a standalone personal umbrella and an in-home business policy on a nationwide basis."

Market segment

"Our commercial insurance lines are actually specialty lines. On the property side, we write commercial fire business and difference in conditions insurance domestically, which includes earthquake, land subsidence and can include flood. That is a major product for us. In fact, we will probably do $70 million of that business this year in California alone.

"On the casualty side, we write primary liability insurance, which includes owner, landlord and tenant business in addition to some products and mercantile business for Main Street-type general liability. In addition, we write excess casualty on either an excess liability form or a commercial umbrella form over a standard liability policy.

RLI Corp.
9025 N. Lindbergh Drive
Peoria, IL 61615-1431
309-692-1000
309-692-1068 FAX

For example, if a business has $1 million in underlying coverage, we may place $5 million of coverage on top of that layer.

"We also have a very nice and profitable surety book of business. We write commercial surety including bid bonds, notary public bonds and bonds for small contractors. We then have an oil and gas surety operation through our acquisition of Underwriters Indemnity Company of Houston, Texas. For the most part, that business is plugging and abandonment bonds for oil and gas wells. That is a very profitable book of business for RLI, as are all of our books of business."

JONATHAN E. MICHAEL
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Making money

"The way we make money is by not paying out as much in expenses and claims as the premiums we take in. We have been able to do this year in and year out. Last year our combined ratio was about 95%, which means that we made $5 on every $100 of insurance we underwrote for the year. In years past, our combined ratios have ranged from a low in the high 80s to 96%, which is where we are going to end up, generally speaking. That is how we make money on the underwriting side.

"In addition to that, obviously, insurance companies take in premiums and — particularly with liability business — hold those premiums for a long period of time. In some lines of business, we have the ability to invest our policyholder's funds in a bond portfolio and earn the interest off that portfolio. Fundamentally speaking, as long as our losses do not outstrip our premiums, meaning that we have a combined ratio of under 100%, the money we make off the loss reserves we have invested is our stockholders' money. Its primary use is as a backup for the policyholders' obligations. But if it is not needed for that purpose, it ends up with the stockholders.

"If you are a profitable underwriting company on a fairly predictable basis, you don't have to depend on the investment income from the loss reserves to make up for shortfalls on the underwriting side. That's what really sets RLI apart. Our underwriting performance lets us invest up to 100% of our stockholder's equity in a value-based equity portfolio that pays dividends. In fact, our equity portfolio has returned over 17% compounded year in and year out. Our strategy of underwriting for profit, investing our policyholders' funds in a conservative bond portfolio and investing the shareholders' funds in a value-based, dividend-yielding equity portfolio, has been a very good business model for RLI."

Interest rate variations

"Interest rates in the short term can have a dramatic effect on any portfolio, but for the most part, our bonds are invested into a held-to-maturity portfolio. Of our $400 million bond portfolio, about three-quarters of it is held-to-maturity and is to be used for future policyholder obligations. The other $100 million in bonds that we hold are invested on a very conservative basis and fluctuate with interest rates. We mark that portfolio 'to market.' Of course, our equity portfolio is impacted by interest rates and a significant portion of our portfolio is invested in electric utility stocks, which are interest-rate-sensitive and can therefore be positively or negatively impacted.

"However, our investment manager, locally owned David Vaughan Investments, has managed our in-

"Our strategy is to underwrite for profit and hire the best talent in the industry."
— JONATHAN E. MICHAEL

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RLI Corp.

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vestments since 1982. David Vaughan's philosophy is the same as ours — buy high-quality investments and hold them for a long time. Our turnover is less than 5% a year; it is a very income-tax-efficient portfolio. We have almost $160 million of unrealized gains in the portfolio, which means that we are holding over $50 million of the federal government's money that is earning interest. It's a pretty neat model."

Reinsurance coverage

"The reinsurance marketplace is experiencing a lot of difficulty right now and the overall property/casualty insurance marketplace is hardening. In particular, pricing is firming, terms are getting better and capacity is shrinking, particularly in the specialty lines that we offer. This year the reinsurance industry had about a 114 combined ratio, meaning that for each $100 they brought in, they lost $14. Conversely, the insurance industry's combined ratio was 110.5, which means that the reinsurers did somewhat worse than the general market. As I said before, RLI was at 95. Because of these conditions, reinsurers are now demanding and getting price increases of around 15% on the business they underwrite. In response, we can either get a 15% rate increase from our customers or combine a smaller rate increase with reduced broker commissions to achieve an overall 15% rate increase.

"Understand that we cede about 40% of gross premiums to reinsurers. So we get a 15% rate increase on 100% of the premium, whereas they only get 15% on the 40% that we cede. In the end, the market works its way out. There are times when the reinsurers are a little bit ahead and times when cedents like us stay a little bit ahead. I think that kind of friction is actually very healthy for the marketplace, as is the fact that the reinsurers are getting rate increases. The rate increases are reasonable and, in my view, they may help the hard market to last a little longer."

Policy size

"Under our casualty insurance product, we can write up to $25 million of commercial umbrella or up to $25 million of directors and officers liability. We can also write up to $25 million on a fire policy or up to $25 million on our earthquake lines, although we rarely do. Our earthquake lines are typically at the $5 million level, but our net for any one risk is limited to about $1 million. So, yes — we do need reinsurance.

"The reason our reinsurance costs are as high as they are is because of the catastrophe markets. We rely on a very large catastrophe cover to write earthquake policies. Among our reinsurance covers, we place $250 million of catastrophe reinsurance in various ways for an event. In addition to that, we write facultative coverages that add another $75 to $100 million, so we believe that our exposure is well contained within our reinsurance.

"We allow our underwriters to write to about 80% of the capacity of our catastrophe reinsurance and are very comfortable with how we write the earthquake cover. We believe that we are the best catastrophe underwriters and, in fact, we have been writing that business in California longer than any other insurance company. Any of our brokers would tell you that RLI is the company to which they look to make the market."

Growth strategy

"Certainly, we are going to have to do some collaboration with other markets to effectively and efficiently deliver product to the buying public, but I believe that we will continue to grow as a specialty company. For the next 12 to 24 months, I do not see us in the acquisition mode. This is the time for our company to really underwrite the business and gain organic growth from some of the initiatives we put in place over the past four to five years in preparation for this hard market. We added units and underwriters in anticipation of the day when the specialty property and casualty insurance marketplace would harden, and that is what we are focused on doing right now."

Internet technology

"RLI has been using the Internet for a number of years to deliver products to its customers and currently has about ten such systems on line. For example, we have a delivery system for our personal umbrella line that enables agents to quote and bind policies over the Internet and know immediately if the customer qualifies for that coverage.

"On the surety side, all of our surety bonds are delivered through a forms library, which is hooked up via the Internet to the surety agent to deliver product. We believe that is the leading edge in the surety bond industry. Previously, the surety bond industry had been a staid, old industry. Today the agent is able to put bonds together very quickly and efficiently, and deliver them right from their personal computer.

"On the commercial side, we have a product called e-XS, and we expect to do $15 million of that business this year. This is high-quality excess liability business and because we have built very defined risks into our e-XS software, the agent is able to underwrite that product right out of the box. The benefit to the agent is that he or she doesn't have to seek four or five different market quotes, but instead can simply call quotes up from RLI's web site. Agents can bind and print the policy right in their office. Our brokers love the efficiencies afforded by the system."

Recruiting new agents

"RLI has 18 offices nationwide and our underwriters each have a following within their specific industry. In general, these are very specialized people who bring value to the very difficult risks that we are underwriting. Through their relationships, we are able to develop other business such as our e-XS product. Here, we can give the agents very attractive, plain-vanilla-type risks that end up in the specialty market. We are able to put them in a box and underwrite them that way.

"However, most of our marketing is done through word-of-mouth referral and face-to-face meetings. What the agents find attractive about our company is the fact that we allow them to make money. We pay a fair commission, are very easy to work with and have highly effective systems that allow the agents and brokers to make money. We expect them to bring value to the transaction."

Named to Ward's 50

"Ward Financial Group, a Cincinnati-based management consulting firm specializing in the insurance industry, does an in-depth analysis of the insurance industry each year and chooses the 50 top performing insurance companies, which are then named in Ward's 50. RLI Corp. has again been named to Ward's 50 and in doing so, joins a group of only 12 other property and casualty insurance companies nationwide that have been named to this prestigious list for 10 consecutive years. The analysis recognizes the companies that have excelled at balancing safety, consistency and performance for the preceding five years by benchmarking their performance against the industry overall."

Dividend history

"We're very proud of our dividend history. In the second quarter of this year, we announced our 100th consecutive payment to shareholders, which will be paid this July. That's 26 straight years of dividend payments, a history any company would point to with satisfaction.

"Not only have we always made dividends a priority, but we've also tried to look after our internal associates. When our chairman and founder, Jerry Stephens, started this company, we became an ESOP company almost immediately. As a matter of fact, even before the ESOP law became law, we had a thrift-type plan to enable our employees to become owners of the company. Today our employees own about 12% of the company and insiders hold 23% of the stock.

"At about the time we became an ESOP company, we also started paying dividends. Jerry believed that the company should start paying a small dividend and increase it every year to create a longevity record that would be very enticing to the investing public. We have continued that since that time and in fact, very safely pay a dividend today. The Handbook of Dividend Achievers is published by Mergent FIS, which is the former Financial Information Services division of Moody's Investor Service and recognizes companies that have increased their dividends annually for at least 10 consecutive calendar years.

"RLI has actually raised its cash dividend for 24 consecutive years. To compile the Top 50 , the dividend histories of more than 28,000 publicly held companies were evaluated and ranked by average compounded dividend growth rate over a ten-year period. RLI ranked 190th on the list, which is an outstanding achievement. We are in a very elite group of dividend achievers and are very proud of that record."

Strategy going forward

"Our strategy is to underwrite for profit and hire the best talent in the industry. That strategy has remained steadfast for a number of years, and we plan to continue along that path. We believe in the three streams of income that our business model functions under and focus on providing customer solutions on the operating side, which means bringing talent to the table and allowing that talent to make decisions. On the claims side, we also have very talented personnel to handle these complex claims."

Most important decision

"Very clearly the most important decision the board of directors had to make was with regard to succession plans for the company's senior management. The board elected to continue the plan that was started three or four years ago by Jerry Stephens, which was for me to step up to chief executive officer. Today we have very able senior management across the company."

Attracting potential investors

"It's our business model. This is what allows us to take advantage of all three streams of income available to a well-run property and casualty insurance company. First, we make a profit underwriting our business. Second, the fact that we normally don't have to use investments to pay claims means we receive 100% of the investment income generated by our portfolio.

"Finally – but still closely tied to our ability to underwrite profitably – we have the luxury of investing in an equity portfolio, which generates significant unrealized gains. All three streams can be found in comprehensive earnings, which has outpaced net earnings by 50% over the past five calendar years, and is the true income measurement of our company."