

MERCURY GENERAL CORP  
Form 10-K  
February 09, 2017

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-K

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ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Fiscal Year Ended December 31, 2016  
Commission File No. 001-12257

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MERCURY GENERAL CORPORATION  
(Exact name of registrant as specified in its charter)

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|   |   |
|---|---|
| California<br>(State or other jurisdiction<br>of incorporation or organization) | 95-2211612<br>(I.R.S. Employer<br>Identification No.) |
|---|---|

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|  |                     |
|--|---------------------|
| 4484 Wilshire Boulevard, Los Angeles, California<br>(Address of principal executive offices) | 90010<br>(Zip Code) |
|--|---------------------|

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Registrant's telephone number, including area code: (323) 937-1060

Securities registered pursuant to Section 12(b) of the Act:

|                     |   |
|---------------------|---|
| Title of Each Class | Name of Each Exchange on Which Registered |
| Common Stock        | New York Stock Exchange                   |

Securities registered pursuant to Section 12(g) of the Act:

NONE

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Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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Large accelerated filer

Accelerated filer

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No   
The aggregate market value of the Registrant's common equity held by non-affiliates of the Registrant at June 30, 2016 was \$1,444,361,346 (which represents 27,170,078 shares of common equity held by non-affiliates multiplied by \$53.16, the closing sales price on the New York Stock Exchange for such date, as reported by the Wall Street Journal).

At February 3, 2017, the Registrant had issued and outstanding an aggregate of 55,289,077 shares of its Common Stock.

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Documents Incorporated by Reference

Certain information from the Registrant's definitive proxy statement for the 2017 Annual Meeting of Shareholders is incorporated herein by reference into Part III hereof.

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## PART I

## Item 1. Business

## General

Mercury General Corporation ("Mercury General") and its subsidiaries (referred to herein collectively as the "Company") are primarily engaged in writing personal automobile insurance through 14 insurance subsidiaries (referred to herein collectively as the "Insurance Companies") in 11 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical breakdown, and umbrella insurance. The Company's insurance policies are mostly sold through independent agents who receive a commission for selling policies. The Company believes that it has thorough underwriting and claims handling processes that, together with its agent relationships, provide the Company with competitive advantages.

The direct premiums written for the years ended December 31, 2016, 2015, and 2014 by state and line of insurance business were:

## Year Ended December 31, 2016

(Dollars in thousands)

|                             | Private<br>Passenger<br>Automobile | Homeowners | Commercial<br>Automobile | Other Lines | Total       |        |
|-----------------------------|------------------------------------|------------|--------------------------|-------------|-------------|--------|
| California                  | \$2,059,459                        | \$369,407  | \$86,981                 | \$104,854   | \$2,620,701 | 82.6 % |
| Florida <sup>(1)</sup>      | 154,593                            | 9          | 24,973                   | 1,067       | 180,642     | 5.7 %  |
| Other states <sup>(2)</sup> | 238,651                            | 67,481     | 54,112                   | 10,310      | 370,554     | 11.7 % |
| Total                       | \$2,452,703                        | \$436,897  | \$166,066                | \$116,231   | \$3,171,897 | 100.0% |
|                             | 77.3                               | % 13.8     | % 5.2                    | % 3.7       | % 100.0     | %      |

## Year Ended December 31, 2015

(Dollars in thousands)

|                             | Private<br>Passenger<br>Automobile | Homeowners | Commercial<br>Automobile | Other Lines | Total       |        |
|-----------------------------|------------------------------------|------------|--------------------------|-------------|-------------|--------|
| California                  | \$1,946,922                        | \$333,397  | \$78,735                 | \$96,791    | \$2,455,845 | 81.5 % |
| Florida <sup>(1)</sup>      | 153,206                            | 9          | 27,281                   | 738         | 181,234     | 6.0 %  |
| Other states <sup>(2)</sup> | 245,645                            | 68,843     | 47,495                   | 13,834      | 375,817     | 12.5 % |
| Total                       | \$2,345,773                        | \$402,249  | \$153,511                | \$111,363   | \$3,012,896 | 100.0% |
|                             | 77.9                               | % 13.3     | % 5.1                    | % 3.7       | % 100.0     | %      |

## Year Ended December 31, 2014

(Dollars in thousands)

|                             | Private<br>Passenger<br>Automobile | Homeowners | Commercial<br>Automobile | Other Lines | Total       |        |
|-----------------------------|------------------------------------|------------|--------------------------|-------------|-------------|--------|
| California                  | \$1,852,291                        | \$302,493  | \$69,129                 | \$84,374    | \$2,308,287 | 80.9 % |
| Florida <sup>(1)</sup>      | 131,281                            | 7          | 26,234                   | 4,676       | 162,198     | 5.7 %  |
| Other states <sup>(2)</sup> | 239,501                            | 71,936     | 40,565                   | 30,682      | 382,684     | 13.4 % |
| Total                       | \$2,223,073                        | \$374,436  | \$135,928                | \$119,732   | \$2,853,169 | 100.0% |
|                             | 77.9                               | % 13.1     | % 4.8                    | % 4.2       | % 100.0     | %      |

- (1) The Company is writing and expects to continue writing nominal premiums in the Florida homeowners market.
- (2) No individual state accounts for more than 4% of total direct premiums written.

The Company offers the following types of automobile coverage: collision, property damage, bodily injury ("BI"), comprehensive, personal injury protection ("PIP"), underinsured and uninsured motorist, and other hazards.

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The Company offers the following types of homeowners coverage: dwelling, liability, personal property, fire, and other hazards.

The following table presents the Company's published maximum limits of liability, net of reinsurance:

| Insurance type                                    | Published maximum limits of liability                       |
|---|---|
| Private Passenger Automobile - bodily injury (BI) | \$250,000 per person; \$500,000 per accident <sup>(1)</sup> |
| Private Passenger Automobile - property damage    | \$250,000 per accident <sup>(1)</sup>                       |
| Commercial Automobile (combined policy limits)    | \$1,000,000 per accident                                    |
| Homeowner property                                | no maximum <sup>(2) (3)</sup>                               |
| Homeowner liability                               | \$1,000,000 <sup>(3)</sup>                                  |
| Umbrella liability                                | \$5,000,000 <sup>(4)</sup>                                  |

<sup>(1)</sup> The majority of the Company's automobile policies have liability limits that are equal to or less than \$100,000 per person and \$300,000 per accident for BI and \$50,000 per accident for property damage.

<sup>(2)</sup> The Company obtains facultative reinsurance above a Company retention limit of up to \$7 million.

<sup>(3)</sup> The majority of the Company's homeowner policies have liability limits of \$300,000 or less and a replacement value of \$500,000 or less.

<sup>(4)</sup> The majority of the Company's umbrella policies have liability limits of \$1,000,000.

The principal executive offices of Mercury General are located in Los Angeles, California. The home office of the Insurance Companies and the information technology center are located in Brea, California. The Company also owns office buildings in Rancho Cucamonga and Folsom, California, which are used to support California operations and future expansion, and in Clearwater, Florida and in Oklahoma City, Oklahoma, which house Company employees and several third party tenants. The Company has approximately 4,200 employees. The Company maintains branch offices in a number of locations in California; Clearwater, Florida; Bridgewater, New Jersey; Oklahoma City, Oklahoma; and Austin and San Antonio, Texas.

#### Available Information

The Company's website address is [www.mercuryinsurance.com](http://www.mercuryinsurance.com). The Company's website address is not intended to function as a hyperlink and the information contained on the Company's website is not, and should not be considered part of, and is not incorporated by reference into, this Annual Report on Form 10-K. The Company makes available on its website its Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements, and amendments to such periodic reports and proxy statements (the "SEC Reports") filed with or furnished to the Securities and Exchange Commission (the "SEC") pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after each SEC Report is filed with or furnished to the SEC. In addition, copies of the SEC Reports are available, without charge, upon written request to the Company's Chief Financial Officer, Mercury General Corporation, 4484 Wilshire Boulevard, Los Angeles, California 90010. The Company's SEC Reports may be read and copied at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains the SEC Reports that the Company has filed or furnished electronically with the SEC.

#### Organization

Mercury General, an insurance holding company, is the parent of Mercury Casualty Company, a California automobile insurer founded in 1961 by George Joseph, the Company's Chairman of the Board of Directors.





Mercury General conducts its business through the following subsidiaries:

| Insurance Companies  | Formed or Acquired | A.M. Best Rating | Primary States     |
|--|--------------------|------------------|--------------------|
| Mercury Casualty Company ("MCC") <sup>(1)</sup>                                | 1961               | A+               | CA, AZ, NV, NY, VA |
| Mercury Insurance Company ("MIC") <sup>(1)</sup>                               | 1972               | A+               | CA                 |
| California Automobile Insurance Company ("CAIC") <sup>(1)</sup>                | 1975               | A+               | CA                 |
| California General Underwriters Insurance Company, Inc. ("CGU") <sup>(1)</sup> | 1985               | Non-rated        | CA                 |
| Mercury Insurance Company of Illinois  | 1989               | A+               | IL, PA             |
| Mercury Insurance Company of Georgia   | 1989               | A+               | GA                 |
| Mercury Indemnity Company of Georgia   | 1991               | A+               | GA                 |
| Mercury National Insurance Company   | 1991               | A+               | IL, MI             |
| American Mercury Insurance Company   | 1996               | A-               | OK, GA, TX, VA     |
| American Mercury Lloyds Insurance Company ("AML")                              | 1996               | A-               | TX                 |
| Mercury County Mutual Insurance Company  | 2000               | A-               | TX                 |
| Mercury Insurance Company of Florida   | 2001               | A+               | FL, PA             |
| Mercury Indemnity Company of America   | 2001               | A+               | FL, NJ             |
| Workmen's Auto Insurance Company ("WAIC") <sup>(1)(2)</sup>                    | 2015               | Non-rated        | CA                 |

  

| Non-Insurance Companies                             | Formed or Acquired | Purpose                             |
|---|--------------------|-------------------------------------|
| Mercury Select Management Company, Inc.             | 1997               | AML's attorney-in-fact              |
| Mercury Insurance Services LLC                      | 2000               | Management services to subsidiaries |
| AIS Management LLC                                  | 2009               | Parent company of AIS and PoliSeek  |
| Auto Insurance Specialists LLC ("AIS")              | 2009               | Insurance agency                    |
| PoliSeek AIS Insurance Solutions, Inc. ("PoliSeek") | 2009               | Insurance agency                    |
| Animas Funding LLC ("AFL")                          | 2013               | Special purpose investment vehicle  |
| Fannette Funding LLC ("FFL")                        | 2014               | Special purpose investment vehicle  |

<sup>(1)</sup> The term "California Companies" refers to MCC, MIC, CAIC, CGU, and WAIC.

<sup>(2)</sup> WAIC was acquired on January 2, 2015. For more detailed information, see Note 20. Acquisition, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

#### Production and Servicing of Business

The Company sells its policies through approximately 9,700 independent agents, its 100% owned insurance agencies, AIS and PoliSeek, and directly through internet sales portals. All of the independent agents collectively accounted for more than 87% of the Company's direct premiums written in 2016, and no single independent agent accounted for more than 1% of the Company's direct premiums written during the last three years. Approximately 1,900 of the independent agents are located in California and approximately 1,500 are located in Florida. The independent agents are independent contractors selected and contracted by the Company and generally also represent competing insurance companies. AIS and PoliSeek represented the Company as independent agents prior to their acquisition in 2009, and continue to act as independent agents selling policies for a number of other insurance companies. Policies sold directly through the internet sales portals are assigned to and serviced by the Company's agents, including AIS and PoliSeek.

The Company believes that it compensates its agents above the industry average. Net commissions incurred in 2016 were approximately 16% of net premiums written.

The Company's advertising budget is allocated among television, radio, newspaper, internet, and direct mailing media with the intent to provide the best coverage available within targeted media markets. While the majority of these advertising costs are borne by the Company, a portion of these costs are reimbursed by the Company's independent agents based upon the number of account leads generated by the advertising. The Company believes that its advertising program is important to generate leads, create brand awareness, and remain competitive in the current

insurance climate. In 2016, the Company incurred approximately \$40 million in net advertising expense.

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### Underwriting

The Company sets its own automobile insurance premium rates, subject to rating regulations issued by the Department of Insurance or similar governmental agency of each state in which it is licensed to operate ("DOI"). Each state has different rate approval requirements. See "Regulation—Department of Insurance Oversight."

The Company offers standard, non-standard, and preferred private passenger automobile insurance in 11 states. The Company also offers homeowners insurance in 11 states, commercial automobile insurance in 9 states, and mechanical breakdown insurance in most states.

In California, "good drivers," as defined by the California Insurance Code, accounted for approximately 82% of all California voluntary private passenger automobile policies-in-force at December 31, 2016, while higher risk categories accounted for approximately 18%. The private passenger automobile renewal rate in California (the rate of acceptance of offers to renew) averages approximately 96%.

### Claims

The Company conducts the majority of claims processing without the assistance of outside adjusters. The claims staff administers all claims and manages all legal and adjustment aspects of claims processing.

### Loss and Loss Adjustment Expense Reserves ("Loss Reserves") and Reserve Development

The Company maintains loss reserves for both reported and unreported claims. Loss reserves for reported claims are estimated based upon a case-by-case evaluation of the type of claim involved and the expected development of such claims. Loss reserves for unreported claims are determined on the basis of historical information by line of insurance business. Inflation is reflected in the reserving process through analysis of cost trends and review of historical reserve settlement.

The Company's ultimate liability may be greater or less than management estimates of reported loss reserves. The Company does not discount to a present value that portion of loss reserves expected to be paid in future periods. However, the Company is required to discount loss reserves for federal income tax purposes.

The following table provides a reconciliation of beginning and ending estimated reserve balances for the years indicated:

#### RECONCILIATION OF NET LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

|  | Year Ended December 31, |              |              |
|--|-------------------------|--------------|--------------|
|  | 2016                    | 2015         | 2014         |
|  | (Amounts in thousands)  |              |              |
| Gross reserves at January 1 <sup>(1)</sup>               | \$ 1,146,688            | \$ 1,091,797 | \$ 1,038,984 |
| Less reinsurance recoverable                             | (14,253 )               | (14,192 )    | (13,635 )    |
| Net reserves at January 1 <sup>(1)</sup>                 | 1,132,435               | 1,077,605    | 1,025,349    |
| Acquisition of WAIC reserves                             | —                       | 18,677       | —            |
| Incurred losses and loss adjustment expenses related to: |                         |              |              |
| Current year   | 2,269,769               | 2,132,837    | 1,989,315    |
| Prior years  | 85,369                  | 12,658       | (3,193 )     |
| Total incurred losses and loss adjustment expenses       | 2,355,138               | 2,145,495    | 1,986,122    |
| Loss and loss adjustment expense payments related to:    |                         |              |              |
| Current year   | 1,508,362               | 1,455,245    | 1,347,967    |
| Prior years  | 702,124                 | 654,097      | 585,899      |
| Total payments   | 2,210,486               | 2,109,342    | 1,933,866    |
| Net reserves at December 31 <sup>(1)</sup>               | 1,277,087               | 1,132,435    | 1,077,605    |
| Reinsurance recoverable                                  | 13,161                  | 14,253       | 14,192       |
| Gross reserves at December 31 <sup>(1)</sup>             | \$ 1,290,248            | \$ 1,146,688 | \$ 1,091,797 |

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(1) Under statutory accounting principles ("SAP"), reserves are stated net of reinsurance recoverable whereas under U.S. generally accepted accounting principles ("GAAP"), reserves are stated gross of reinsurance recoverable.

The increase in the provision for insured events of prior years in 2016 of approximately \$85.4 million primarily resulted from the California and Florida automobile lines of business, which experienced loss severities in prior accident periods that were higher than previously estimated.

The increase in the provision for insured events of prior years in 2015 of approximately \$12.7 million primarily resulted from the California homeowners and automobile lines of business outside of California, which was partially offset by favorable development in the California automobile line of business.

The decrease in the provision for insured events of prior years in 2014 of approximately \$3.2 million primarily resulted from lower than expected loss severity on California personal automobile lines of insurance business partially offset by adverse development in other states.

The Company experienced estimated pre-tax catastrophe losses and loss adjustment expenses from severe weather events of \$27 million, \$19 million, and \$11 million in 2016, 2015, and 2014, respectively. The losses in 2016 primarily resulted from severe storms outside of California and rainstorms in California. The losses in 2015 primarily resulted from severe storms outside of California, and rainstorms and wildfires in California. The losses in 2014 were primarily related to winter freeze events on the East Coast and severe rainstorms in California.

#### Statutory Accounting Principles

The Company's results are reported in accordance with GAAP, which differ in some respects from amounts reported under SAP prescribed by insurance regulatory authorities. Some of the significant differences under GAAP are described below:

Policy acquisition costs such as commissions, premium taxes, and other costs that vary with and are primarily related to the successful acquisition of new and renewal insurance contracts, are capitalized and amortized on a pro rata basis over the period in which the related premiums are earned, whereas under SAP, these costs are expensed as incurred. Certain assets are included in the consolidated balance sheets, whereas under SAP, such assets are designated as "nonadmitted assets," and charged directly against statutory surplus. These assets consist primarily of premium receivables that are outstanding for more than 90 days, deferred tax assets that do not meet statutory requirements for recognition, furniture, equipment, leasehold improvements, capitalized software, and prepaid expenses. Amounts related to ceded reinsurance are shown gross as prepaid reinsurance premiums and reinsurance recoverables, whereas under SAP, these amounts are netted against unearned premium reserves and loss and loss adjustment expense reserves.

Fixed-maturity securities are reported at fair value, whereas under SAP, these securities are reported at amortized cost, or the lower of amortized cost, or fair value, depending on the specific type of security.

Equity securities are marked to market through the consolidated statements of operations, whereas under SAP, these securities are marked to market through unrealized gains and losses in surplus.

Goodwill is reported as the excess of cost of an acquired entity over the fair value of the underlying assets and assessed periodically for impairment. Intangible assets are amortized over their useful lives. Under SAP, goodwill is reported as the excess of cost of an acquired entity over the statutory book value and amortized over 10 years. Its carrying value is limited to 10% of adjusted surplus. Under SAP, intangible assets are not recognized.

The differing treatment of income and expense items results in a corresponding difference in federal income tax expense. Changes in deferred income taxes are reflected as an item of income tax benefit or expense, whereas under SAP, changes in deferred income taxes are recorded directly to statutory surplus as regards policyholders. Admittance testing under SAP may result in a charge to unassigned surplus for non-admitted portions of deferred tax assets. Under GAAP, a valuation allowance may be recorded against the deferred tax assets and reflected as an expense.

Certain assessments paid to regulatory agencies that are recoverable from policyholders in future periods are expensed, whereas under SAP, these assessments are recorded as receivables.

#### Operating Ratios (SAP basis)

#### Loss and Expense Ratios

Loss and expense ratios are used to evaluate the underwriting experience of property and casualty insurance companies. Under SAP, losses and loss adjustment expenses are stated as a percentage of premiums earned because losses occur over the life of a policy, while underwriting expenses are stated as a percentage of premiums written rather than premiums earned because

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most underwriting expenses are incurred when policies are written and are not spread over the policy period. The statutory underwriting profit margin is the extent to which the combined loss and expense ratios are less than 100%. The following table presents, on a statutory basis, the Insurance Companies' loss, expense and combined ratios, and the private passenger automobile industry combined ratio. Although the Insurance Companies' ratios include lines of insurance business other than private passenger automobile that accounted for 22.7% of direct premiums written in 2016, the Company believes its ratios can be compared to the industry ratios.

|   | Year Ended December 31, |         |                       |         |         |
|---|-------------------------|---------|-----------------------|---------|---------|
|   | 2016                    | 2015    | 2014                  | 2013    | 2012    |
| Loss ratio  | 75.3 %                  | 72.6 %  | 71.0 %                | 72.7 %  | 76.1 %  |
| Expense ratio   | 25.7 %                  | 26.7 %  | 27.7 %                | 27.2 %  | 26.7 %  |
| Combined ratio  | 101.0%                  | 99.3 %  | 98.8 % <sup>(2)</sup> | 99.9 %  | 102.8 % |
| Industry combined ratio (all writers) <sup>(1)</sup>              | N/A                     | 104.1 % | 101.9 %               | 103.4 % | 101.3 % |
| Industry combined ratio (excluding direct writers) <sup>(1)</sup> | N/A                     | 100.2 % | 99.8 %                | 100.7 % | 102.6 % |

<sup>(1)</sup> Source: A.M. Best, Aggregates & Averages (2012 through 2015), for all property and casualty insurance companies (private passenger automobile line only, after policyholder dividends).

<sup>(2)</sup> Combined ratio for 2014 does not sum due to rounding.

#### Premiums to Surplus Ratio

The following table presents the Insurance Companies' statutory ratios of net premiums written to policyholders' surplus. Guidelines established by the National Association of Insurance Commissioners (the "NAIC") indicate that this ratio should be no greater than 3 to 1.

|                        | Year Ended December 31,               |             |             |             |             |
|------------------------|---------------------------------------|-------------|-------------|-------------|-------------|
|                        | 2016                                  | 2015        | 2014        | 2013        | 2012        |
|                        | (Amounts in thousands, except ratios) |             |             |             |             |
| Net premiums written   | \$3,155,788                           | \$2,999,392 | \$2,840,922 | \$2,728,999 | \$2,651,731 |
| Policyholders' surplus | \$1,441,571                           | \$1,451,950 | \$1,438,281 | \$1,528,682 | \$1,440,973 |
| Ratio                  | 2.2 to 1                              | 2.1 to 1    | 2.0 to 1    | 1.8 to 1    | 1.8 to 1    |

#### Investments

The Company's investments are directed by the Chief Investment Officer under the supervision of the Investment Committee of the Board of Directors. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve a return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company believes that this strategy maintains the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for monitoring credit exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

Tax considerations, including the impact of the alternative minimum tax ("AMT"), are important in portfolio management. Changes in loss experience, growth rates, and profitability produce significant changes in the Company's exposure to AMT liability, requiring appropriate shifts in the investment asset mix among taxable bonds, tax-exempt bonds, equities, and other investments in order to maximize after-tax yield. The Company closely monitors the timing and recognition of capital gains and losses and the generation of ordinary income to maximize the realization of any deferred tax assets arising from capital losses or AMT credit carryforwards, respectively. The Company had no capital loss carryforward at December 31, 2016.





## Investment Portfolio

The following table presents the composition of the Company's total investment portfolio:

|                                      | December 31,           |             |                     |             |                     |             |
|--------------------------------------|------------------------|-------------|---------------------|-------------|---------------------|-------------|
|                                      | 2016                   |             | 2015                |             | 2014                |             |
|                                      | Cost <sup>(1)</sup>    | Fair Value  | Cost <sup>(1)</sup> | Fair Value  | Cost <sup>(1)</sup> | Fair Value  |
|                                      | (Amounts in thousands) |             |                     |             |                     |             |
| Taxable bonds                        | \$373,335              | \$375,495   | \$426,905           | \$414,396   | \$350,343           | \$350,705   |
| Tax-exempt state and municipal bonds | 2,422,075              | 2,439,058   | 2,377,370           | 2,465,607   | 2,153,151           | 2,267,695   |
| Total fixed maturities               | 2,795,410              | 2,814,553   | 2,804,275           | 2,880,003   | 2,503,494           | 2,618,400   |
| Equity securities                    | 331,770                | 357,327     | 313,528             | 315,362     | 387,851             | 412,880     |
| Short-term investments               | 375,700                | 375,680     | 185,353             | 185,277     | 373,180             | 372,542     |
| Total investments                    | \$3,502,880            | \$3,547,560 | \$3,303,156         | \$3,380,642 | \$3,264,525         | \$3,403,822 |

<sup>(1)</sup> Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost.

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time the eligible item is first recognized. For more detailed discussion on the Company's investment portfolio, including credit ratings, see "Liquidity and Capital Resources—C. Invested Assets" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 3. Investments, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

## Investment Results

The following table presents the investment results of the Company for the most recent five years:

|   | Year Ended December 31, |             |             |             |             |   |
|---|-------------------------|-------------|-------------|-------------|-------------|---|
|   | 2016                    | 2015        | 2014        | 2013        | 2012        |   |
|   | (Dollars in thousands)  |             |             |             |             |   |
| Average invested assets at cost <sup>(1) (2)</sup>        | \$3,390,769             | \$3,293,948 | \$3,204,592 | \$3,028,198 | \$3,011,143 |   |
| Net investment income <sup>(3)</sup>                      |                         |             |             |             |             |   |
| Before income taxes                                       | \$121,871               | \$126,299   | \$125,723   | \$124,538   | \$131,896   |   |
| After income taxes  | \$107,140               | \$110,382   | \$111,456   | \$109,506   | \$115,359   |   |
| Average annual yield on investments <sup>(3)</sup>        |                         |             |             |             |             |   |
| Before income taxes                                       | 3.6                     | % 3.8       | % 3.9       | % 4.1       | % 4.4       | % |
| After income taxes  | 3.2                     | % 3.4       | % 3.5       | % 3.6       | % 3.8       | % |
| Net realized investment (losses) gains after income taxes | \$(22,266 )             | \$(54,474 ) | \$52,770    | \$(7,424 )  | \$43,147    |   |

<sup>(1)</sup> Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each period.

<sup>(2)</sup> At December 31, 2016, fixed maturity securities with call features totaled \$2.8 billion at fair value and amortized cost.

During 2016, net investment income before and after income taxes and average annual yields on investments after income taxes decreased slightly, primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments.

## Competitive Conditions

The Company operates in the highly competitive property and casualty insurance industry subject to competition on pricing, claims handling, consumer recognition, coverage offered and product features, customer service, and geographic coverage. Some of the Company's competitors are larger and well-capitalized national companies that sell directly to consumers or have broad distribution networks of employed or captive agents.

Reputation for customer service and price are the principal means by which the Company competes with other insurers. In addition, the marketing efforts of independent agents can provide a competitive advantage. Based on the most recent regularly

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published statistical compilations of premiums written in 2016, the Company was the fourth largest writer of private passenger automobile insurance in California and the fourteenth largest in the United States.

The property and casualty insurance industry is highly cyclical, with alternating hard and soft market conditions. The Company has historically seen premium growth during hard market conditions. The Company believes that the market is hardening with carriers generally raising rates, although this also depends on individual state profitability and the carriers' growth appetite.

#### Reinsurance

For California homeowners policies, the Company has reduced its catastrophe exposure from earthquakes by placing earthquake risks directly with the California Earthquake Authority ("CEA"). However, the Company continues to have catastrophe exposure to fires following an earthquake. For more detailed discussion, see "Regulation—Insurance Assessments" below.

The Company is party to a Catastrophe Reinsurance Treaty ("Treaty") covering a wide range of perils that is effective through June 30, 2017. The Treaty provides for \$115 million of coverage on a per occurrence basis after covered catastrophe losses exceed a \$100 million Company retention limit. The first \$100 million of losses above the Company's \$100 million retention are covered 100% by the reinsurers. Losses above \$200 million are shared pro-rata with 5% coverage by the reinsurers and 95% retention by the Company, up to \$15 million total coverage provided by the reinsurers. The treaty specifically excludes coverage for California earthquake losses on fixed property policies, such as homeowners, but does cover losses from fires following an earthquake.

The Company has reinsurance for PIP claims in Michigan through the Michigan Catastrophic Claims Association, a private non-profit unincorporated association created by the Michigan Legislature. The reinsurance covers losses in excess of \$545,000 per person and has no maximum limit. Michigan law provides for unlimited lifetime coverage for medical costs caused by automobile accidents. The Company ceased writing personal automobile insurance in Michigan in 2016.

The Company carries a commercial umbrella reinsurance treaty and seeks facultative arrangements for large property risks. In addition, the Company has other reinsurance in force that is not material to the consolidated financial statements. If any reinsurers are unable to perform their obligations under a reinsurance treaty, the Company will be required, as primary insurer, to discharge all obligations to its policyholders in their entirety.

#### Regulation

The Insurance Companies are subject to significant regulation and supervision by insurance departments of the jurisdictions in which they are domiciled or licensed to operate business.

#### Department of Insurance Oversight

The powers of the DOI in each state primarily include the prior approval of insurance rates and rating factors and the establishment of capital and surplus requirements, solvency standards, restrictions on dividend payments and transactions with affiliates. DOI regulations and supervision are designed principally to benefit policyholders rather than shareholders.

California Proposition 103 (the "Proposition") requires that property and casualty insurance rates be approved by the California DOI prior to their use and that no rate be approved which is excessive, inadequate, unfairly discriminatory, or otherwise in violation of the provisions of the Proposition. The Proposition specifies four statutory factors required to be applied in "decreasing order of importance" in determining rates for private passenger automobile insurance: (1) the insured's driving safety record, (2) the number of miles the insured drives annually, (3) the number of years of driving experience of the insured and (4) whatever optional factors are determined by the California DOI to have a substantial relationship to risk of loss and are adopted by regulation. The statute further provides that insurers are

required to give at least a 20% discount to "good drivers," as defined, from rates that would otherwise be charged to such drivers and that no insurer may refuse to insure a "good driver." The Company's rate plan operates under these rating factor regulations.

Insurance rates in California, Georgia, New York, New Jersey, and Nevada require prior approval from the state DOI, while insurance rates in Illinois, Texas, Virginia, and Arizona must only be filed with the respective DOI before they are implemented. Oklahoma and Florida have a modified version of prior approval laws. Insurance laws and regulations in all states in which the Company operates provide that rates must not be excessive, inadequate, or unfairly discriminatory.

The DOI in each state in which the Company operates is responsible for conducting periodic financial and market conduct examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices. For more detailed

information on the Company's current financial and market conduct examinations, see "Liquidity and Capital Resources—F. Regulatory Capital Requirements" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

For a discussion of current regulatory matters in California, see "Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 17. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

The operations of the Company are dependent on the laws of the states in which it does business and changes in those laws can materially affect the revenue and expenses of the Company. The Company retains its own legislative advocates in California. The Company made direct financial contributions of approximately \$307,000 and \$21,000 to officeholders and candidates in 2016 and 2015, respectively. The Company believes in supporting the political process and intends to continue to make such contributions in amounts which it determines to be appropriate.

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The risk-based capital ("RBC") formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance business having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2016, 2015, and 2014, each of the Insurance Companies exceeded the minimum required RBC level. For more detailed information, see "Liquidity and Capital Resources—F. Regulatory Capital Requirements" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

#### Own Risk and Solvency Assessment

Insurance companies are required to file an Own Risk and Solvency Assessment ("ORSA") with the insurance regulators in their domiciliary states. The ORSA is required to cover, among many items, a company's risk management policies, the material risks to which the company is exposed, how the company measures, monitors, manages and mitigates material risks, and how much economic and regulatory capital is needed to continue to operate in a strong and healthy manner. The ORSA is intended to be used by state insurance regulators to evaluate the risk exposure and quality of the risk management processes within insurance companies to assist in conducting risk-focused financial examinations and for determining the overall financial condition of insurance companies. The Company filed its most recent ORSA Summary Report with the California DOI in November 2016. Compliance with the ORSA requirements did not have a material impact on the Company's consolidated financial statements.

#### Insurance Assessments

The California Insurance Guarantee Association ("CIGA") was created to pay claims on behalf of insolvent property and casualty insurers. Each year, these claims are estimated by CIGA and the Company is assessed for its pro-rata share based on prior year California premiums written in the particular line. These assessments are currently limited to 2.0% of premiums written in the preceding year and are recouped through a mandated surcharge to policyholders in the year after the assessment. There were no CIGA assessments in 2016.

The CEA is a quasi-governmental organization that was established to provide a market for earthquake coverage to California homeowners. The Company places all new and renewal earthquake coverage offered with its homeowner policy directly with the CEA. The Company receives a small fee for placing business with the CEA, which is recorded as other revenue in the consolidated statements of operations. Upon the occurrence of a major seismic event, the CEA has the ability to assess participating companies for losses. These assessments are made after CEA capital has been

expended and are based upon each company's participation percentage multiplied by the amount of the total assessment. Based upon the most recent information provided by the CEA, the Company's maximum total exposure to CEA assessments at April 1, 2016, the most recent date at which information was available, was \$60.2 million. There was no assessment made in 2016.

The Insurance Companies in other states are also subject to the provisions of similar insurance guaranty associations. There were no material assessments or payments during 2016 in other states.

#### Holding Company Act

The California Companies are subject to California DOI regulation pursuant to the provisions of the California Insurance Holding Company System Regulatory Act (the "Holding Company Act"). The California DOI may examine the affairs of each of the California Companies at any time. The Holding Company Act requires disclosure of any material transactions among affiliates

within a holding company system. Some transactions and dividends defined to be "extraordinary" may not be made if the California DOI disapproves the transaction within 30 days after notice. Such transactions include, but are not limited to, extraordinary dividends; management agreements, service contracts, and cost-sharing arrangements; all guarantees that are not quantifiable; derivative transactions or series of derivative transactions; certain reinsurance transactions or modifications thereof in which the reinsurance premium or a change in the insurer's liabilities equals or exceeds 5% of the policyholders' surplus as of the preceding December 31; sales, purchases, exchanges, loans, and extensions of credit; and investments, in the net aggregate, involving more than the lesser of 3% of the respective California Companies' admitted assets or 25% of statutory surplus as regards policyholders as of the preceding December 31. An extraordinary dividend is a dividend which, together with other dividends or distributions made within the preceding 12 months, exceeds the greater of 10% of the insurance company's statutory policyholders' surplus as of the preceding December 31 or the insurance company's statutory net income for the preceding calendar year.

California-domiciled insurance companies are also required to notify the California DOI of any dividend after declaration, but prior to payment. There are similar limitations imposed by other states on the Insurance Companies' ability to pay dividends. As of December 31, 2016, the Insurance Companies are permitted to pay in 2017, without obtaining DOI approval for extraordinary dividends, \$144 million in dividends to Mercury General, of which \$116 million may be paid by the California Companies.

The Holding Company Act also provides that the acquisition or change of "control" of a California domiciled insurance company or of any person who controls such an insurance company cannot be consummated without the prior approval of the California DOI. In general, a presumption of "control" arises from the ownership of voting securities and securities that are convertible into voting securities, which in the aggregate constitute 10% or more of the voting securities of a California insurance company or of a person that controls a California insurance company, such as Mercury General. A person seeking to acquire "control," directly or indirectly, of the Company must generally file with the California DOI an application for change of control containing certain information required by statute and published regulations and provide a copy of the application to the Company. The Holding Company Act also effectively restricts the Company from consummating certain reorganizations or mergers without prior regulatory approval.

Each of the Insurance Companies is subject to holding company regulations in the state in which it is domiciled. These provisions are substantially similar to those of the Holding Company Act.

#### Assigned Risks

Automobile liability insurers in California are required to sell BI liability, property damage liability, medical expense, and uninsured motorist coverage to a proportionate number (based on the insurer's share of the California automobile casualty insurance market) of those drivers applying for placement as "assigned risks." Drivers seek placement as assigned risks because their driving records or other relevant characteristics, as defined by the Proposition, make them difficult to insure in the voluntary market. In 2016, assigned risks represented less than 0.1% of total automobile direct premiums written and less than 0.1% of total automobile direct premium earned. The Company attributes the low level of assignments to the competitive voluntary market. Many of the other states in which the Company conducts business offer programs similar to that of California. These programs are not a significant contributor to the business written in those states.

## Executive Officers of the Company

The following table presents certain information concerning the executive officers of the Company as of February 3, 2017:

| Name                  | Age | Position  |
|-----------------------|-----|---|
| George Joseph         | 95  | Chairman of the Board                               |
| Gabriel Tirador       | 52  | President and Chief Executive Officer               |
| Allan Lubitz          | 58  | Senior Vice President and Chief Information Officer |
| Theodore R. Stalick   | 53  | Senior Vice President and Chief Financial Officer   |
| Christopher Graves    | 51  | Vice President and Chief Investment Officer         |
| Robert Houlihan       | 60  | Vice President and Chief Product Officer            |
| Kenneth G. Kitzmiller | 70  | Vice President and Chief Underwriting Officer       |
| Brandt N. Minnich     | 50  | Vice President and Chief Marketing Officer          |
| Randall R. Petro      | 53  | Vice President and Chief Claims Officer             |
| Heidi C. Sullivan     | 48  | Vice President and Chief Human Capital Officer      |
| Charles Toney         | 55  | Vice President and Chief Actuary                    |
| Judy A. Walters       | 70  | Vice President—Corporate Affairs and Secretary      |

Mr. Joseph, Chairman of the Board of Directors, has served in this capacity since 1961. He held the position of Chief Executive Officer of the Company for 45 years from 1961 through 2006. Mr. Joseph has more than 50 years' experience in the property and casualty insurance business.

Mr. Tirador, President and Chief Executive Officer, served as the Company's assistant controller from 1994 to 1996. In 1997 and 1998, he served as the Vice President and Controller of the Automobile Club of Southern California. He rejoined the Company in 1998 as Vice President and Chief Financial Officer. He was appointed President and Chief Operating Officer in October 2001 and Chief Executive Officer in 2007. Mr. Tirador has over 20 years' experience in the property and casualty insurance industry and is an inactive Certified Public Accountant.

Mr. Lubitz, Senior Vice President and Chief Information Officer, joined the Company in 2008. Prior to joining the Company, he served as Senior Vice President and Chief Information Officer of H&R Block/Option One Mortgage from 2003 to 2007. He held executive roles including Chief Information Officer of Ditech Mortgage and President of ANR Consulting Group from 2000 to 2003. Prior to 2000, he held several positions at TRW, Experian, and First American Corporation, most recently as a Senior Vice President and Chief Information Officer.

Mr. Stalick, Senior Vice President and Chief Financial Officer, joined the Company as Corporate Controller in 1997. He was appointed Chief Accounting Officer in October 2000 and Vice President and Chief Financial Officer in 2001. In July 2013, he was named Senior Vice President and Chief Financial Officer. Mr. Stalick is an inactive Certified Public Accountant.

Mr. Graves, Vice President and Chief Investment Officer, has been employed by the Company in the investment department since 1986. Mr. Graves was appointed Chief Investment Officer in 1998, and named Vice President in 2001.

Mr. Houlihan, Vice President and Chief Product Officer, joined the Company in his current position in 2007. Prior to joining the Company, he served as National Product Manager at Bristol West Insurance Group from 2005 to 2007 and Product Manager at Progressive Insurance Company from 1999 to 2005.

Mr. Kitzmiller, Vice President and Chief Underwriting Officer, has been employed by the Company in the underwriting department since 1972. Mr. Kitzmiller was appointed Vice President in 1991, and named Chief Underwriting Officer in 2010.



Mr. Minnich, Vice President and Chief Marketing Officer, joined the Company as an underwriter in 1989. In 2007, he joined Superior Access Insurance Services as Director of Agency Operations. In 2008 he rejoined the Company as an Assistant Product Manager, and in 2009, he was named Senior Director of Marketing, a role he held until appointed to his current position later in 2009. Mr. Minnich has over 25 years' experience in the property and casualty insurance industry and is a Chartered Property and Casualty Underwriter.

Mr. Petro, Vice President and Chief Claims Officer, has been employed by the Company in the Claims Department since 1987. Mr. Petro was appointed Vice President in March 2014, and named Chief Claims Officer in March 2015.

Ms. Sullivan, Vice President and Chief Human Capital Officer, joined the Company in 2012. Prior to joining the Company, she served as Senior Vice President, Human Capital for Arcadian Health Plan from 2008 to 2012. Prior to 2008, she held various leadership positions at Kaiser Permanente, Progressive Insurance, and Score Educational Centers.

Mr. Toney, Vice President and Chief Actuary, joined the Company in 1984 as a programmer/analyst. In 1994, he earned his Fellowship in the Casualty Actuarial Society and was appointed to his current position. In 2011, he became a board member of the Personal Insurance Federation of California. Mr. Toney is Mr. Joseph's nephew.

Ms. Walters, Vice President—Corporate Affairs and Secretary, has been employed by the Company since 1967, and has served as its Secretary since 1982. Ms. Walters was named Vice President—Corporate Affairs in 1998.

#### Item 1A. Risk Factors

The Company's business involves various risks and uncertainties in addition to the normal risks of business, some of which are discussed in this section. It should be noted that the Company's business and that of other insurers may be adversely affected by a downturn in general economic conditions and other forces beyond the Company's control. In addition, other risks and uncertainties not presently known or that the Company currently believes to be immaterial may also adversely affect the Company's business. Any such risks or uncertainties, or any of the following risks or uncertainties, that develop into actual events could result in a material and adverse effect on the Company's business, financial condition, results of operations, or liquidity.

The information discussed below should be considered carefully with the other information contained in this Annual Report on Form 10-K and the other documents and materials filed by the Company with the SEC, as well as news releases and other information publicly disseminated by the Company from time to time. The following risk factors are in no particular order.

#### Risks Related to the Company's Business

The Company remains highly dependent upon California to produce revenues and operating profits. For the year ended December 31, 2016, the Company generated 82.0% of its direct automobile insurance premiums written in California. The Company's financial results are subject to prevailing regulatory, legal, economic, demographic, competitive, and other conditions in the states in which the Company operates and changes in any of these conditions could negatively impact the Company's results of operations.

Mercury General is a holding company that relies on regulated subsidiaries for cash flows to satisfy its obligations. As a holding company, Mercury General maintains no operations that generate cash flows sufficient to pay operating expenses, shareholders' dividends, or principal or interest on its indebtedness. Consequently, Mercury General relies on the ability of the Insurance Companies, particularly the California Companies, to pay dividends for Mercury General to meet its obligations. The ability of the Insurance Companies to pay dividends is regulated by state insurance laws, which limit the amount of, and in certain circumstances may prohibit the payment of, cash dividends. Generally, these insurance regulations permit the payment of dividends only out of earned surplus in any year which, together with other dividends or distributions made within the preceding 12 months, do not exceed the greater of 10% of statutory surplus as of the end of the preceding year or the net income for the preceding year, with larger dividends payable only after receipt of prior regulatory approval. The inability of the Insurance Companies to pay dividends in an amount sufficient to enable the Company to meet its cash requirements at the holding company level could have a material adverse effect on the Company's results of operations, financial condition, and its ability to pay dividends to its shareholders.

The Insurance Companies are subject to minimum capital and surplus requirements, and any failure to meet these requirements could subject the Insurance Companies to regulatory action.

The Insurance Companies are subject to risk-based capital standards and other minimum capital and surplus requirements imposed under the applicable laws of their states of domicile. The risk-based capital standards, based upon the Risk-Based Capital Model Act adopted by the NAIC, require the Insurance Companies to report their results of RBC calculations to state departments of insurance and the NAIC. If any of the Insurance Companies fails to meet these standards and requirements, the DOI regulating such subsidiary may require specified actions by the subsidiary.

The Company's success depends on its ability to accurately underwrite risks and to charge adequate premiums to policyholders.

The Company's financial condition, results of operations, and liquidity depend on its ability to underwrite and set premiums accurately for the risks it assumes. Premium rate adequacy is necessary to generate sufficient premium to offset losses, loss

adjustment expenses, and underwriting expenses and to earn a profit. In order to price its products accurately, the Company must collect and properly analyze a substantial volume of data; develop, test, and apply appropriate rating formulae; closely monitor and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. The Company's ability to undertake these efforts successfully, and as a result, price accurately, is subject to a number of risks and uncertainties, including but not limited to:

- availability of sufficient reliable data;
- incorrect or incomplete analysis of available data;
- uncertainties inherent in estimates and assumptions, generally;
- selection and application of appropriate rating formulae or other pricing methodologies;
- successful innovation of new pricing strategies;
- recognition of changes in trends and in the projected severity and frequency of losses;
- the Company's ability to forecast renewals of existing policies accurately;
- unanticipated court decisions, legislation or regulatory action;
- ongoing changes in the Company's claim settlement practices;
- changes in operating expenses;
- changing driving patterns;
- extra-contractual liability arising from bad faith claims;
- weather catastrophes, including those which may be related to climate change;
- unexpected medical inflation; and
- unanticipated inflation in automobile repair costs, automobile parts prices, and used car prices.

Such risks and uncertainties may result in the Company's pricing being based on outdated, inadequate or inaccurate data, or inappropriate analyses, assumptions or methodologies, and may cause the Company to estimate incorrectly future changes in the frequency or severity of claims. As a result, the Company could underprice risks, which would negatively affect the Company's margins, or it could overprice risks, which could reduce the Company's volume and competitiveness. In either event, the Company's financial condition, results of operations, and liquidity could be materially and adversely affected.

The Company's insurance rates are subject to approval by the departments of insurance in most of the states in which the Company operates, and to political influences.

In five of the states in which it operates, including California, the Company must obtain the DOI's prior approval of insurance rates charged to its customers, including any increases in those rates. If the Company is unable to receive approval of the rate changes it requests, or if such approval is delayed, the Company's ability to operate its business in a profitable manner may be limited and its financial condition, results of operations, and liquidity may be adversely affected. Additionally, in California, the law allows for consumer groups to intervene in rate filings, which frequently causes delays in rate approvals and implementation of rate changes and can impact the rate that is ultimately approved.

From time to time, the automobile insurance industry comes under pressure from state regulators, legislators, and special interest groups to reduce, freeze, or set rates at levels that do not correspond with underlying costs, in the opinion of the Company's management. The homeowners insurance business faces similar pressure, particularly as regulators in catastrophe-prone states seek an acceptable methodology to price for catastrophe exposure. In addition, various insurance underwriting and pricing criteria regularly come under attack by regulators, legislators, and special interest groups. The result could be legislation, regulations, or new interpretations of existing regulations that adversely affect the Company's business, financial condition, and results of operations.

The effects of emerging claim and coverage issues on the Company's business are uncertain and may have an adverse effect on the Company's business.

As industry practices and legal, judicial, social, and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect the Company's

business by either extending coverage beyond its underwriting intent or by increasing the number or size of claims. In some instances, these changes may not

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become apparent until sometime after the Company has issued insurance policies that are affected by the changes. As a result, the full extent of liability under the Company's insurance policies may not be known for many years after a policy is issued.

Loss of, or significant restriction on, the use of credit scoring in the pricing and underwriting of personal lines products could reduce the Company's future profitability.

The Company uses credit scoring as a factor in pricing and underwriting decisions where allowed by state law. Some consumer groups and regulators have questioned whether the use of credit scoring unfairly discriminates against some groups of people and are seeking to prohibit or restrict the use of credit scoring in underwriting and pricing. Laws or regulations that significantly curtail or regulate the use of credit scoring, if enacted in a large number of states in which the Company operates, could negatively impact the Company's future results of operations.

If the Company cannot maintain its A.M. Best ratings, it may not be able to maintain premium volume in its insurance operations sufficient to attain the Company's financial performance goals.

The Company's ability to retain its existing business or to attract new business in its Insurance Companies is affected by its rating by A.M. Best Company. A.M. Best Company currently rates all of the Insurance Companies with sufficient operating history to be rated as either A+ (Superior) or A- (Excellent). On June 15, 2016, A.M. Best Company affirmed all of the Company's ratings and revised the ratings outlook for the A+ rated entities from Stable to Negative, signaling the possibility for a ratings downgrade in the future. The Company believes that any downgrade would be within the A rating range, which is considered Excellent, and would not have a significant impact on the Company's business. The Company is also working to remove the Negative outlook back to Stable in the next ratings cycle, which is expected to occur in 2017. The Company believes that if it is unable to maintain its A.M. Best ratings within the A ratings range, it may face greater challenges to grow its premium volume sufficiently to attain its financial performance goals, which may adversely affect the Company's business, financial condition, and results of operations. Two of the smaller Insurance Companies, California General Underwriters Insurance Company, Inc. and Workmen's Auto Insurance Company, are not rated by A.M. Best Company and the rating is not critical to the type of business they produce.

The Company may require additional capital in the future, which may not be available or may only be available on unfavorable terms.

The Company's future capital requirements, including to fund future growth opportunities, depend on many factors, including its ability to underwrite new business successfully, its ability to establish premium rates and reserves at levels sufficient to cover losses, the success of its expansion plans, the performance of its investment portfolio and its ability to obtain financing. The Company may seek to obtain financing through equity or debt issuances, or sales of all or a portion of its investment portfolio or other assets. The Company's ability to obtain financing also depends on economic conditions affecting financial markets and financial strength and claims-paying ability ratings, which are assigned based upon an evaluation of the Company's ability to meet its financial obligations. The Company's current financial strength rating with Fitch is A+. If the Company were to seek financing through the capital markets in the future, it may need to apply for Standard and Poor's or Moody's ratings and there can be no assurance that the Company would obtain favorable ratings from either agency. Any equity or debt financing, if available at all, may not be available on terms that are favorable to the Company. In the case of equity financing, the Company's shareholders could experience dilution. In addition, such securities may have rights, preferences, and privileges that are senior to those of the Company's current shareholders. If the Company cannot obtain adequate capital on favorable terms or at all, its business, financial condition, and results of operations could be adversely affected.

Changes in market interest rates, defaults on securities and tax considerations may have an adverse effect on the Company's investment portfolio, which may adversely affect the Company's financial results.

The Company's financial results are affected, in part, by the performance of its investment portfolio. The Company's investment portfolio contains interest rate sensitive-investments, such as municipal and corporate bonds. Increases in

market interest rates may have an adverse impact on the value of the investment portfolio by decreasing the value of fixed income securities. Declining market interest rates could have an adverse impact on the Company's investment income as it invests positive cash flows from operations and as it reinvests proceeds from maturing and called investments in new investments that could yield lower rates than the Company's investments have historically generated. Defaults in the Company's investment portfolio may produce operating losses and negatively impact the Company's results of operations.

Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions, and other factors beyond the Company's control. Market interest rates have been at historic lows for the last several years. Many observers, including the Company, believe that market interest rates will rise as the economy improves. Although the Company takes measures to manage the risks of investing in a changing interest rate environment, it may

not be able to mitigate interest rate sensitivity effectively. The Company's mitigation efforts include maintaining a high quality portfolio and managing the duration of the portfolio to reduce the effect of interest rate changes. Despite its mitigation efforts, a significant change in interest rates could have a material adverse effect on the Company's financial condition and results of operations. In addition, changes in loss experience, growth rates and profitability of the Company's investment portfolio significantly impact the Company's exposure to AMT liability. The Company seeks to manage its AMT liability and maximize after-tax yield through the appropriate investment asset mix between taxable bonds, tax-exempt bonds, and equities. Although the Company monitors the timing and recognition of capital gains and losses and the generation of ordinary income in an effort to maximize the realization of deferred tax assets arising from capital losses or AMT credit carryforwards, no guaranty can be provided that such monitoring or the Company's tax strategies will be effective.

If interest rates rise, the Company's debt service costs will increase.

Interest expense on the Company's notes payable is directly tied to short-term LIBOR rates, which tend to move in conjunction with the short-term bank borrowing rates (the "Fed Funds Rate") established by the Federal Reserve Bank. The interest expense on the Company's notes payable will increase if short-term LIBOR rates experience increases. Higher interest expense could have an adverse impact on the Company's financial condition, results of operations and liquidity.

The Company's valuation of financial instruments may include methodologies, estimates, and assumptions that are subject to differing interpretations and could result in changes to valuations that may materially adversely affect the Company's financial condition or results of operations.

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price.

Accordingly, when market observable data are not readily available, the Company's own assumptions are set to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date.

Assets and liabilities recorded on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with the inputs used to measure their fair value and the level of market price observability.

During periods of market disruption, including periods of significantly changing interest rates, rapidly widening credit spreads, inactivity or illiquidity, it may be difficult to value certain of the Company's securities if trading becomes less frequent and/or market data become less observable. There may be certain asset classes in historically active markets with significant observable data that become illiquid due to changes in the financial environment. In such cases, the valuations associated with such securities may rely more on management's judgment and include inputs and assumptions that are less observable or require greater estimation as well as valuation methods that are more sophisticated or require greater estimation. The valuations generated by such methods may be different from the value at which the investments ultimately may be sold. Further, rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within the Company's consolidated financial statements, and the period-to-period changes in value could vary significantly. Decreases in value may have a material adverse effect on the Company's financial condition or results of operations.

Changes in the financial strength ratings of financial guaranty insurers issuing policies on bonds held in the Company's investment portfolio may have an adverse effect on the Company's investment results.

In an effort to enhance the bond rating applicable to certain bond issues, some bond issuers purchase municipal bond insurance policies from private insurers. The insurance generally guarantees the payment of principal and interest on a bond issue if the issuer defaults. By purchasing the insurance, the financial strength ratings applicable to the bonds are based on the credit worthiness of the insurer as well as the underlying credit of the bond issuer. These financial guaranty insurers are subject to DOI oversight. As the financial strength ratings of these insurers are reduced, the ratings of the insured bond issues correspondingly decrease. Although the Company has determined that the financial strength ratings of the underlying bond issues in its investment portfolio are within the Company's investment policy



without the enhancement provided by the insurance policies, any further downgrades in the financial strength ratings of these insurance companies or any defaults on the insurance policies written by these insurance companies may reduce the fair value of the underlying bond issues and the Company's investment portfolio or may reduce the investment results generated by the Company's investment portfolio, which could have a material adverse effect on the Company's financial condition, results of operations, and liquidity.

Deterioration of the municipal bond market in general or of specific municipal bonds held by the Company may result in a material adverse effect on the Company's financial condition, results of operations, and liquidity.

At December 31, 2016, 68.8% of the Company's total investment portfolio at fair value and 86.7% of its total fixed maturity investments at fair value were invested in tax-exempt municipal bonds. With such a large percentage of the Company's investment portfolio invested in municipal bonds, the performance of the Company's investment portfolio, including the cash flows generated

by the investment portfolio, is significantly dependent on the performance of municipal bonds. If the value of municipal bond markets in general or any of the Company's municipal bond holdings deteriorates, the performance of the Company's investment portfolio, financial condition, results of operations, and liquidity may be materially and adversely affected.

If the Company's loss reserves are inadequate, its business and financial position could be harmed. The process of establishing property and liability loss reserves is inherently uncertain due to a number of factors, including underwriting quality, the frequency and amount of covered losses, variations in claims settlement practices, the costs and uncertainty of litigation, and expanding theories of liability. While the Company believes that its actuarial techniques and databases are sufficient to estimate loss reserves, the Company's approach may prove to be inadequate. If any of these contingencies, many of which are beyond the Company's control, results in loss reserves that are not sufficient to cover its actual losses, the Company's financial condition, results of operations, and liquidity may be materially and adversely affected.

There is uncertainty involved in the availability of reinsurance and the collectability of reinsurance recoverable. The Company reinsures a portion of its potential losses on the policies it issues to mitigate the volatility of the losses on its financial condition and results of operations. The availability and cost of reinsurance is subject to market conditions, which are outside of the Company's control. From time to time, market conditions have limited, and in some cases, prevented insurers from obtaining the types and amounts of reinsurance that they consider adequate for their business needs. As a result, the Company may not be able to successfully purchase reinsurance and transfer a portion of the Company's risk through reinsurance arrangements. In addition, as is customary, the Company initially pays all claims and seeks to recover the reinsured losses from its reinsurers. Although the Company reports as assets the amount of claims paid which the Company expects to recover from reinsurers, no assurance can be given that the Company will be able to collect from its reinsurers. If the amounts actually recoverable under the Company's reinsurance treaties are ultimately determined to be less than the amount it has reported as recoverable, the Company may incur a loss during the period in which that determination is made.

The failure of any loss limitation methods employed by the Company could have a material adverse effect on its financial condition or results of operations.

Various provisions of the Company's policies, such as limitations or exclusions from coverage which are intended to limit the Company's risks, may not be enforceable in the manner the Company intends. In addition, the Company's policies contain conditions requiring the prompt reporting of claims and the Company's right to decline coverage in the event of a violation of that condition. While the Company's insurance product exclusions and limitations reduce the Company's loss exposure and help eliminate known exposures to certain risks, it is possible that a court or regulatory authority could nullify or void an exclusion or legislation could be enacted modifying or barring the use of such endorsements and limitations in a way that would adversely affect the Company's loss experience, which could have a material adverse effect on its financial condition or results of operations.

The Company's business is vulnerable to significant catastrophic property loss, which could have an adverse effect on its financial condition and results of operations.

The Company faces a significant risk of loss in the ordinary course of its business for property damage resulting from natural disasters, man-made catastrophes and other catastrophic events, particularly hurricanes, earthquakes, hail storms, explosions, tropical storms, fires, sinkholes, war, acts of terrorism, severe weather and other natural and man-made disasters. Such events typically increase the frequency and severity of automobile and other property claims. Because catastrophic loss events are by their nature unpredictable, historical results of operations may not be indicative of future results of operations, and the occurrence of claims from catastrophic events may result in substantial volatility in the Company's financial condition and results of operations from period to period. Although the Company attempts to manage its exposure to such events, the occurrence of one or more major catastrophes in any given period could have a material and adverse impact on the Company's financial condition and results of operations and could result in substantial outflows of cash as losses are paid.

The Company depends on independent agents who may discontinue sales of its policies at any time. The Company sells its insurance policies primarily through approximately 9,700 independent agents. The Company must compete with other insurance carriers for these agents' business. Some competitors offer a larger variety of products, lower prices for insurance coverage, higher commissions, or more attractive non-cash incentives. To maintain its relationship with these independent agents, the Company must pay competitive commissions, be able to respond to their needs quickly and adequately, and create a consistently high level of customer satisfaction. If these independent agents find it preferable to do business with the Company's competitors, it would be difficult to renew the Company's existing business or attract new business. State regulations may also limit the manner in which the Company's producers are compensated or incentivized. Such developments could negatively impact the Company's relationship with these parties and ultimately reduce revenues.

The Company's expansion plans may adversely affect its future profitability.

The Company intends to continue to expand its operations in several of the states in which the Company has operations and into states in which it has not yet begun operations. The intended expansion will necessitate increased expenditures. The Company intends to fund these expenditures out of cash flows from operations. The expansion may not occur, or if it does occur, may not be successful in providing increased revenues or profitability. If the Company's cash flows from operations are insufficient to cover the costs of the expansion, or if the expansion does not provide the benefits anticipated, the Company's financial condition, results of operations, and ability to grow its business may be harmed.

Any inability of the Company to realize its deferred tax assets, if and when they arise, may have a material adverse effect on the Company's financial condition and results of operations.

The Company recognizes deferred tax assets and liabilities for the future tax consequences related to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for tax credits. The Company evaluates its deferred tax assets for recoverability based on available evidence, including assumptions about future profitability and capital gain generation. Although management believes that it is more likely than not that the deferred tax assets will be realized, some or all of the Company's deferred tax assets could expire unused if the Company is unable to generate taxable income of an appropriate character and in a sufficient amount to utilize these tax benefits in the future. Any determination that the Company would not be able to realize all or a portion of its deferred tax assets in the future would result in a charge to earnings in the period in which the determination is made. This charge could have a material adverse effect on the Company's results of operations and financial condition. In addition, the assumptions used to make this determination are subject to change from period to period based on changes in tax laws or variances between the Company's projected operating performance and actual results. As a result, significant management judgment is required in assessing the possible need for a deferred tax asset valuation allowance. For these reasons and because changes in these assumptions and estimates can materially affect the Company's results of operations and financial condition, management has included the assessment of a deferred tax asset valuation allowance as a critical accounting estimate.

The carrying value of the Company's goodwill and other intangible assets could be subject to an impairment write-down.

At December 31, 2016, the Company's consolidated balance sheets reflected approximately \$43 million of goodwill and \$26 million of other intangible assets. The Company evaluates whether events or circumstances have occurred that suggest that the fair values of its intangible assets are below their respective carrying values. The determination that the fair value of the Company's intangible assets is less than its carrying value may result in an impairment write-down. An impairment write-down would be reflected as expense and could have a material adverse effect on the Company's results of operations during the period in which it recognizes the expense. In the future, the Company may incur impairment charges related to goodwill and other intangible assets already recorded or arising out of future acquisitions.

The Company relies on its information technology systems to manage many aspects of its business, and any failure of these systems to function properly or any interruption in their operation could result in a material adverse effect on the Company's business, financial condition, and results of operations.

The Company depends on the accuracy, reliability, and proper functioning of its information technology systems. The Company relies on these information technology systems to effectively manage many aspects of its business, including underwriting, policy acquisition, claims processing and handling, accounting, reserving and actuarial processes and policies, and to maintain its policyholder data. The Company has deployed, and continues to enhance, new information technology systems that are designed to manage many of these functions across all of the states in which it operates and all of the lines of insurance it offers. See "Overview—A. General—Technology" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." The failure of hardware or software that supports the Company's information technology systems, the loss of data contained in the systems, or any delay or failure in the full deployment of the Company's information technology systems could disrupt its business and

could result in decreased premiums, increased overhead costs, and inaccurate reporting, all of which could have a material adverse effect on the Company's business, financial condition, and results of operations.

In addition, despite system redundancy, the implementation of security measures, and the existence of a disaster recovery plan for the Company's information technology systems, these systems are vulnerable to damage or interruption from:

- earthquake, fire, flood and other natural disasters;
- terrorist attacks and attacks by computer viruses, hackers, phishing, ransomware, or other exploits;
- power loss in areas not covered by backup power generators;
- unauthorized access; and

• computer systems, internet, telecommunications or data network failure.

It is possible that a system failure, accident, or security breach could result in a material disruption to the Company's business. In addition, substantial costs may be incurred to remedy the damages caused by these disruptions. Following implementation of information technology systems, the Company may from time to time install new or upgraded business management systems. To the extent that a critical system fails or is not properly implemented and the failure cannot be corrected in a timely manner, the Company may experience disruptions to the business that could have a material adverse effect on the Company's results of operations.

Cyber security risks and the failure to maintain the confidentiality, integrity, and availability of internal or policyholder systems and data could result in damages to the Company's reputation and/or subject it to expenses, fines or lawsuits.

The Company collects and retains large volumes of internal and policyholder data, including personally identifiable information, for business purposes including underwriting, claims and billing purposes, and relies upon the various information technology systems that enter, process, summarize and report such data. The Company also maintains personally identifiable information about its employees. The confidentiality and protection of the Company's policyholder, employee and Company data are critical to the Company's business. The Company's policyholders and employees have a high expectation that the Company will adequately protect their personal information. The regulatory environment, as well as the requirements imposed by the payment card industry and insurance regulators, governing information, security and privacy laws is increasingly demanding and continues to evolve. Maintaining compliance with applicable information security and privacy regulations may increase the Company's operating costs and adversely impact its ability to market products and services to its policyholders. Furthermore, a penetrated or compromised information technology system or the intentional, unauthorized, inadvertent or negligent release or disclosure of data could result in theft, loss, fraudulent or unlawful use of policyholder, employee or Company data which could harm the Company's reputation or result in remedial and other expenses, fines or lawsuits. Although we seek to mitigate the impact and severity of potential cyber threats through cyber insurance coverage, not every risk or liability can be insured, and for risks that are insurable, the policy limits and terms of coverage reasonably obtainable in the market may not be sufficient to cover all actual losses or liabilities incurred. In addition, disputes with insurance carriers, including over policy terms, reservation of rights, the applicability of coverage (including exclusions), compliance with provisions (including notice) and/or the insolvency of one or more of our insurers may significantly affect the amount or timing of recovery.

Changes in accounting standards issued by the Financial Accounting Standards Board ("the FASB") or other standard-setting bodies may adversely affect the Company's consolidated financial statements.

The Company's consolidated financial statements are subject to the application of GAAP, which is periodically revised and/or expanded. Accordingly, the Company is required to adopt new or revised accounting standards from time to time issued by recognized authoritative bodies, including the FASB. It is possible that future changes the Company is required to adopt could change the current accounting treatment that the Company applies to its consolidated financial statements and that such changes could have a material adverse effect on the Company's financial condition and results of operations.

The Company's disclosure controls and procedures may not prevent or detect acts of fraud.

The Company's disclosure controls and procedures are designed to reasonably assure that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to management and is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Company's management, including its Chief Executive Officer and Chief Financial Officer, believe that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, the Company cannot provide absolute assurance

that all control issues and instances of fraud, if any, within the Company have been prevented or detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by an unauthorized override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and the Company cannot assure that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

Failure to maintain an effective system of internal control over financial reporting may have an adverse effect on the Company's stock price.

The Company is required to include in its Annual Report on Form 10-K a report by its management regarding the effectiveness of the Company's internal control over financial reporting, which includes, among other things, an assessment of the effectiveness

of the Company's internal control over financial reporting as of the end of its fiscal year, including a statement as to whether or not the Company's internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in the Company's internal control over financial reporting identified by management. Areas of the Company's internal control over financial reporting may require improvement from time to time. If management is unable to assert that the Company's internal control over financial reporting is effective now or in any future period, or if the Company's independent auditors are unable to express an opinion on the effectiveness of those internal controls, investors may lose confidence in the accuracy and completeness of the Company's financial reports, which could have an adverse effect on the Company's stock price.

The ability of the Company to attract, develop and retain talented employees, managers and executives, and to maintain appropriate staffing levels, is critical to the Company's success.

The Company is constantly hiring and training new employees and seeking to retain current employees. An inability to attract, retain and motivate the necessary employees for the operation and expansion of the Company's business could hinder its ability to conduct its business activities successfully, develop new products and attract customers.

The Company's success also depends upon the continued contributions of its executive officers, both individually and as a group. The Company's future performance will be substantially dependent on its ability to retain and motivate its management team. The loss of the services of any of the Company's executive officers could prevent the Company from successfully implementing its business strategy, which could have a material adverse effect on the Company's business, financial condition, and results of operations.

Uncertain economic conditions may negatively affect the Company's business and operating results.

Uncertain economic conditions could adversely affect the Company in the form of consumer behavior and pressure on its investment portfolio. Consumer behavior could include policy cancellations, modifications, or non-renewals, which may reduce cash flows from operations and investments, may harm the Company's financial position, and may reduce the Insurance Companies' statutory surplus. Uncertain economic conditions also may impair the ability of the Company's customers to pay premiums as they become due, and as a result, the Company's bad debt reserves and write-offs could increase. It is also possible that claims fraud may increase. The Company's investment portfolios could be adversely affected as a result of financial and business conditions affecting the issuers of the securities in the Company's investment portfolio. In addition, declines in the Company's profitability could result in a charge to earnings for the impairment of goodwill, which would not affect the Company's cash flows but could decrease its earnings, and could adversely affect its stock price.

The Company may be adversely affected if economic conditions result in either inflation or deflation. In an inflationary environment, established reserves may become inadequate and increase the Company's loss ratio, and market interest rates may rise and reduce the value of the Company's fixed maturity portfolio, while increasing interest expense on its LIBOR based debt. The departments of insurance may not approve premium rate increases in time for the Company to adequately mitigate inflated loss costs. In a deflationary environment, some fixed maturity issuers may have difficulty meeting their debt service obligations and thereby reduce the value of the Company's fixed maturity portfolio; equity investments may decrease in value; and policyholders may experience difficulties paying their premiums to the Company, which could adversely affect premium revenue.

#### Risks Related to the Company's Industry

The private passenger automobile insurance industry is highly competitive, and the Company may not be able to compete effectively against larger or better-capitalized companies.

The Company competes with many property and casualty insurance companies selling private passenger automobile insurance in the states in which the Company operates. Many of these competitors are better capitalized than the Company, have higher A.M. Best ratings, and have a larger market share in the states in which the Company operates. The superior capitalization of the competitors may enable them to offer lower rates, to withstand larger losses, and to more effectively take advantage of new marketing opportunities. The Company's competition may also become



increasingly better capitalized in the future as the traditional barriers between insurance companies and banks and other financial institutions erode and as the property and casualty industry continues to consolidate. The Company's ability to compete against these larger, better-capitalized competitors depends on its ability to deliver superior service and its strong relationships with independent agents.

The Company may undertake strategic marketing and operating initiatives to improve its competitive position and drive growth. If the Company is unable to successfully implement new strategic initiatives or if the Company's marketing campaigns do not attract new customers, the Company's competitive position may be harmed, which could adversely affect the Company's business and results of operations. Additionally, in the event of a failure of any competitor, the Company and other insurance companies would likely be required by state law to absorb the losses of the failed insurer and would be faced with an unexpected surge in new business from the failed insurer's former policyholders.

The Company may be adversely affected by changes in the private passenger automobile insurance industry. 77.3% of the Company's direct premiums written for the year ended December 31, 2016 were generated from private passenger automobile insurance policies. Adverse developments in the market for personal automobile insurance or the personal automobile insurance industry in general, whether related to changes in competition, pricing or regulations, could cause the Company's results of operations to suffer. The property-casualty insurance industry is also exposed to the risks of severe weather conditions, such as rainstorms, snowstorms, hail and ice storms, hurricanes, tornadoes, wild fires, sinkholes, earthquakes and, to a lesser degree, explosions, terrorist attacks, and riots. The automobile insurance business is also affected by cost trends that impact profitability. Factors which negatively affect cost trends include inflation in automobile repair costs, automobile parts costs, new and used car valuations, medical costs, and changes in non-economic costs due to changes in the legal and regulatory environments. In addition, the advent of driverless cars and usage-based insurance could materially alter the way that automobile insurance is marketed, priced, and underwritten.

The Company cannot predict the impact that changing climate conditions, including legal, regulatory and social responses thereto, may have on its business.

Various scientists, environmentalists, international organizations, regulators and other commentators believe that global climate change has added, and will continue to add, to the unpredictability, frequency and severity of natural disasters (including, but not limited to, hurricanes, tornadoes, freezes, droughts, other storms and fires) in certain parts of the world. In response, a number of legal and regulatory measures and social initiatives have been introduced in an effort to reduce greenhouse gas and other carbon emissions that may be chief contributors to global climate change. The Company cannot predict the impact that changing climate conditions, if any, will have on its business or its customers. It is also possible that the legal, regulatory and social responses to climate change could have a negative effect on the Company's results of operations or financial condition.

Changes in federal or state tax laws could adversely affect the Company's business, financial condition, results of operations, and liquidity.

The Company's financial condition, results of operations, and liquidity are dependent in part on tax policy implemented at the federal and/or state level. For example, a significant portion of the Company's investment portfolio consists of municipal securities that receive beneficial tax treatment under applicable federal tax law. The Company's results are also subject to federal and state tax rules applicable to dividends received from its subsidiaries and its equity holdings. Additionally, changes in tax laws could have an adverse effect on deferred tax assets and liabilities included in the Company's consolidated balance sheets and results of operations. The Company cannot predict whether any tax legislation will be enacted or whether any such changes to existing federal or state tax law would have a material adverse effect on the Company's financial condition and results of operations.

The insurance industry is subject to extensive regulation, which may affect the Company's ability to execute its business plan and grow its business.

The Company is subject to extensive regulation and supervision by government agencies in each of the states in which its Insurance Companies are domiciled, sell insurance products, issue policies, or manage claims. Some states impose restrictions or require prior regulatory approval of specific corporate actions, which may adversely affect the Company's ability to operate, innovate, obtain necessary rate adjustments in a timely manner or grow its business profitably. These regulations provide safeguards for policyholders and are not intended to protect the interests of shareholders. The Company's ability to comply with these laws and regulations, and to obtain necessary regulatory action in a timely manner is, and will continue to be, critical to its success. Some of these regulations include:

**Required Licensing.** The Company operates under licenses issued by the DOI in the states in which the Company sells insurance. If a regulatory authority denies or delays granting a new license, the Company's ability to enter that market quickly or offer new insurance products in that market may be substantially impaired. In addition, if the DOI in any

state in which the Company currently operates suspends, non-renews, or revokes an existing license, the Company would not be able to offer affected products in that state.

**Transactions Between Insurance Companies and Their Affiliates.** Transactions between the Insurance Companies and their affiliates (including the Company) generally must be disclosed to state regulators, and prior approval of the applicable regulator is required before any material or extraordinary transaction may be consummated. State regulators may refuse to approve or delay approval of some transactions, which may adversely affect the Company's ability to innovate or operate efficiently.

**Regulation of Insurance Rates and Approval of Policy Forms.** The insurance laws of most states in which the Company conducts business require insurance companies to file insurance rate schedules and insurance policy forms for review and approval.

If, as permitted in some states, the Company begins using new rates before they are approved, it may be required to issue refunds or credits to the Company's policyholders if the new rates are ultimately deemed excessive or unfair and disapproved by the applicable state regulator. In other states, prior approval of rate changes is required and there may be long delays in the approval process or the rates may not be approved. Accordingly, the Company's ability to respond to market developments or increased costs in that state can be adversely affected.

**Restrictions on Cancellation, Non-Renewal or Withdrawal.** Most of the states in which the Company operates have laws and regulations that limit its ability to exit a market. For example, these states may limit a private passenger automobile insurer's ability to cancel and non-renew policies or they may prohibit the Company from withdrawing one or more lines of insurance business from the state unless prior approval is received from the state DOI. In some states, these regulations extend to significant reductions in the amount of insurance written, not only to a complete withdrawal. Laws and regulations that limit the Company's ability to cancel and non-renew policies in some states or locations and that subject withdrawal plans to prior approval requirements may restrict the Company's ability to exit unprofitable markets, which may harm its business and results of operations.

**Other Regulations.** The Company must also comply with regulations involving, among other matters:

- the use of non-public consumer information and related privacy issues;
- the use of credit history in underwriting and rating;
- limitations on the ability to charge policy fees;
- limitations on types and amounts of investments;
- the payment of dividends;
- the acquisition or disposition of an insurance company or of any company controlling an insurance company;
- involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;
- reporting with respect to financial condition;
- periodic financial and market conduct examinations performed by state insurance department examiners; and
- the other regulations discussed in this Annual Report on Form 10-K.

The failure to comply with these laws and regulations may also result in regulatory actions, fines and penalties, and in extreme cases, revocation of the Company's ability to do business in that jurisdiction. In addition, the Company may face individual and class action lawsuits by insured and other parties for alleged violations of certain of these laws or regulations.

In addition, from time to time, the Company may support or oppose legislation or other amendments to insurance regulations in California or other states in which it operates. Consequently, the Company may receive negative publicity related to its support or opposition of legislative or regulatory changes that may have a material adverse effect on the Company's financial condition, results of operations, and liquidity.

Regulation may become more restrictive in the future, which may adversely affect the Company's business, financial condition, and results of operations.

No assurance can be given that states will not make existing insurance-related laws and regulations more restrictive in the future or enact new restrictive laws. New or more restrictive regulation in any state in which the Company conducts business could make it more expensive for it to continue to conduct business in these states, restrict the premiums the Company is able to charge or otherwise change the way the Company does business. In such events, the Company may seek to reduce its writings in or to withdraw entirely from these states. In addition, from time to time, the United States Congress and certain federal agencies investigate the current condition of the insurance industry to determine whether federal regulation is necessary. The Company cannot predict whether and to what extent new laws and regulations that would affect its business will be adopted, the timing of any such adoption and what effects, if any, they may have on the Company's business, financial condition, and results of operations.

Assessments and other surcharges for guaranty funds, second-injury funds, catastrophe funds, and other mandatory pooling arrangements may reduce the Company's profitability.

Virtually all states require insurers licensed to do business in their state to bear a portion of the loss suffered by some insured parties as the result of impaired or insolvent insurance companies. Many states also have laws that established second-injury funds to provide compensation to injured employees for aggravation of a prior condition or injury which are funded by either assessments based on paid losses or premium surcharge mechanisms. In addition, as a condition to the ability to conduct business in various

states, the Insurance Companies must participate in mandatory property and casualty shared-market mechanisms or pooling arrangements, which provide various types of insurance coverage to individuals or other entities that otherwise are unable to purchase that coverage from private insurers. The effect of these assessments and mandatory shared-market mechanisms or changes in them could reduce the Company's profitability in any given period or limit its ability to grow its business.

The insurance industry faces litigation risks, which, if resolved unfavorably, could result in substantial penalties and/or monetary damages, including punitive damages. In addition, insurance companies incur material expenses defending litigation and their results of operations or financial condition could be adversely affected if they fail to accurately project litigation expenses.

Insurance companies are subject to a variety of legal actions including breach of contract claims, tort claims, fraud and misrepresentation claims, employee benefit claims, and wage and hour claims. In addition, insurance companies incur and likely will continue to incur potential liability for claims related to the insurance industry in general and to the Company's business in particular, such as those related to allegations for failure to pay claims, termination or non-renewal of coverage, interpretation of policy language, policy sales practices, reinsurance matters, and other similar matters. Such actions can also include allegations of fraud, misrepresentation, and unfair or improper business practices and can include claims for punitive damages.

Court decisions and legislative activity may increase exposures for any of the types of claims insurance companies face. There is a risk that insurance companies could incur substantial legal fees and expenses in any of the actions companies defend in excess of amounts budgeted for defense.

The Company and the Insurance Companies are named as defendants in a number of lawsuits. Those that management believes could have a material effect on the Company's consolidated financial statements are described more fully in "Overview—B. Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 16. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data." Litigation, by its very nature, is unpredictable and the outcome of these cases is uncertain. The precise nature of the relief that may be sought or granted in any lawsuit is uncertain and may negatively impact the manner in which the Company conducts its business, which could materially increase the Company's legal expenses and negatively impact the results of operations. In addition, potential litigation involving new claim, coverage, and business practice issues could adversely affect the Company's business by changing the way policies are priced, extending coverage beyond its underwriting intent, or increasing the size of claims.

#### Risks Related to the Company's Stock

The Company is controlled by a small number of shareholders who will be able to exert significant influence over matters requiring shareholder approval, including change of control transactions.

George Joseph and Gloria Joseph collectively own more than 50% of the Company's common stock. Accordingly, George Joseph and Gloria Joseph have the ability to exert significant influence on the actions the Company may take in the future, including change of control transactions. Certain institutional investors also each own between 5% and 10% of the Company's common stock. This concentration of ownership may conflict with the interests of the Company's other shareholders and lenders.

Future equity or debt financing may affect the market price of the Company's common stock and rights of the current shareholders, and the future exercise of options and granting of shares will result in dilution in the investment of the Company's shareholders.

The Company may raise capital in the future through the issuance and sale of its common stock or debt securities. The Company cannot predict what effect, if any, such future financing will have on the market price of its common stock. Sales of substantial amounts of its common stock in the public market or issuance of substantial amounts of debt securities could adversely affect the market price of the Company's outstanding common stock, and may make it more

difficult for shareholders to sell common stock at a time and price that the shareholder deems appropriate. Furthermore, holders of some of the Company's securities may have rights, preferences, and privileges that are senior to those of the Company's current shareholders. In addition, the Company has issued options to purchase shares of its common stock as well as restricted stock units ("RSUs") to incentivize its executives and key employees. In the event that any options to purchase common stock are exercised or any shares of common stock are issued when the RSUs vest, shareholders will suffer dilution in their investment.

Applicable insurance laws may make it difficult to effect a change of control of the Company or the sale of any of its Insurance Companies.

Before a person can acquire control of a U.S. insurance company or any holding company of a U.S. insurance company, prior written approval must be obtained from the DOI of the state where the insurer is domiciled. Prior to granting approval of an

application to acquire control of the insurer or holding company, the state DOI will consider a number of factors relating to the acquirer and the transaction. These laws and regulations may discourage potential acquisition proposals and may delay, deter or prevent a change of control of the Company or the sale by the Company of any of its Insurance Companies, including transactions that some or all of the Company's shareholders might consider to be desirable.

Although the Company has consistently paid increasing cash dividends in the past, it may not be able to pay or continue to increase cash dividends in the future.

The Company has consistently paid cash dividends since the public offering of its common stock in November 1985 and has consistently increased the dividend per share during that time. However, future cash dividends will depend upon a variety of factors, including the Company's profitability, financial condition, capital needs, future prospects, and other factors deemed relevant by the Board of Directors. The Company's ability to pay dividends or continue to increase the dividend per share may also be limited by the ability of the Insurance Companies to make distributions to the Company, which may be restricted by financial, regulatory or tax constraints, and by the terms of the Company's debt instruments. In addition, there can be no assurance that the Company will continue to pay dividends or increase the dividend per share even if the necessary financial and regulatory conditions are met and if sufficient cash is available for distribution.

#### Item 1B. Unresolved Staff Comments

None.

#### Item 2. Properties

The Company owns the following buildings which are mostly occupied by the Company's employees. Space not occupied by the Company may be leased to independent third party tenants.

| Location             | Purpose                                       | Size in Square Feet | Percent Occupied by the Company at December 31, 2016 |   |
|----------------------|---|---------------------|--|---|
| Brea, CA             | Home office and I.T. facilities (2 buildings) | 236,000             | 100  | % |
| Folsom, CA           | Administrative and Data Center                | 88,000              | 100  | % |
| Los Angeles, CA      | Executive offices                             | 41,000              | 95   | % |
| Rancho Cucamonga, CA | Administrative                                | 127,000             | 100  | % |
| Clearwater, FL       | Administrative                                | 164,000             | 62   | % |
| Oklahoma City, OK    | Administrative                                | 100,000             | 25   | % |

The Company leases additional office space for operations. Office location is not crucial to the Company's operations, and the Company anticipates no difficulty in extending these leases or obtaining comparable office space. In addition, the Company owns 6.3-acre and 5.9-acre parcels of land in Brea and Rancho Cucamonga, California, respectively.

The Company's properties are well maintained, adequately meet its needs, and are being utilized for their intended purposes.

#### Item 3. Legal Proceedings

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see "Overview-C. Critical Accounting Policies and Estimates" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 1. Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."



The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see "Overview—B. Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 17. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data," which is incorporated herein by reference.

There are no environmental proceedings arising under federal, state, or local laws or regulations to be discussed.

Item 4. Mine Safety Disclosure

Not applicable.

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## PART II

## Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

## Market Information

The Company's common shares are listed on the New York Stock Exchange (Symbol: MCY). The following table presents the high and low sales prices per share (as reported on the New York Stock Exchange) during the last two years.

| 2016        | High    | Low     |
|-------------|---------|---------|
| 1st Quarter | \$56.02 | \$42.97 |
| 2nd Quarter | 55.95   | 49.69   |
| 3rd Quarter | 56.14   | 52.00   |
| 4th Quarter | 61.19   | 50.32   |
| 2015        | High    | Low     |
| 1st Quarter | \$60.31 | \$52.28 |
| 2nd Quarter | 59.25   | 53.87   |
| 3rd Quarter | 57.19   | 48.78   |
| 4th Quarter | 54.18   | 45.12   |

The closing price of the Company's common stock on February 3, 2017 was \$62.41.

## Holders

As of February 3, 2017, there were approximately 113 holders of record of the Company's common stock.

## Dividends

Since the public offering of its common stock in November 1985, the Company has paid regular quarterly dividends on its common stock. During 2016 and 2015, the Company paid dividends on its common stock of \$2.4825 and \$2.4725 per share, respectively. On February 3, 2017 the Board of Directors declared a \$0.6225 quarterly dividend payable on March 30, 2017 to shareholders of record on March 16, 2017.

For financial statement purposes, the Company records dividends on the declaration date. The Company intends to continue paying quarterly dividends; however, the continued payment and amount of cash dividends will depend upon the Company's operating results, overall financial condition, capital requirements, and general business conditions.

## Holding Company Act

Pursuant to the Holding Company Act, California-domiciled insurance companies are required to notify the California DOI of any dividend after declaration, but prior to payment. There are similar limitations imposed by other states on the Insurance Companies' ability to pay dividends. As of December 31, 2016, the Insurance Companies are permitted to pay in 2017, without obtaining DOI approval for extraordinary dividends, \$144 million in dividends to Mercury General, of which \$116 million may be paid by the California Companies.

For a discussion of certain restrictions on the payment of dividends to Mercury General by some of its insurance subsidiaries, see Note 12. Dividends, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

## Performance Graph

The following graph compares the cumulative total shareholder returns on the Company's Common Stock (Symbol: MCY) with the cumulative total returns on the Standard and Poor's 500 Composite Stock Price Index ("S&P 500 Index") and the Company's industry peer group over the last five years. The graph assumes that \$100 was invested on December 31, 2011 in each of the Company's Common Stock, the S&P 500 Index and the industry peer group and the reinvestment of all dividends.



|                     | 2011     | 2012    | 2013     | 2014     | 2015     | 2016     |
|---------------------|----------|---------|----------|----------|----------|----------|
| Mercury General     | \$100.00 | \$92.16 | \$122.17 | \$146.49 | \$126.26 | \$170.79 |
| Industry Peer Group | 100.00   | 118.65  | 157.68   | 191.78   | 184.37   | 222.51   |
| S&P 500 Index       | 100.00   | 116.00  | 153.57   | 174.60   | 177.01   | 198.18   |

The industry peer group consists of Alleghany Corporation, Allstate Corporation, American Financial Group, Arch Capital Group Ltd, Berkley (W.R.), Berkshire Hathaway 'B', Chubb Corporation, Cincinnati Financial Corporation, CNA Financial Corporation, Erie Indemnity Company, Hanover Insurance Group, Markel Corporation, Old Republic International, Progressive Corporation, RLI Corporation, Selective Insurance Group, Travelers Companies, Inc., and XL Group, plc.

#### Recent Sales of Unregistered Securities

None.

#### Share Repurchases

The Company has had a stock repurchase program since 1998. The Company's Board of Directors authorized a \$200 million stock repurchase on July 29, 2016, and the authorization will expire in July 2017. The Company may repurchase shares of its common stock under the program in open market transactions at the discretion of management. The Company may use its own funds, borrowings against a bank credit facility, and dividends received from the Insurance Companies to fund the share repurchases. No stock has been purchased since 2000.

#### Item 6. Selected Financial Data

The following selected financial and operating data are derived from the Company's audited consolidated financial statements. The selected financial and operating data should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data."

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|  | Year Ended December 31,                       |              |              |              |              |
|--|---|--------------|--------------|--------------|--------------|
|  | 2016  | 2015         | 2014         | 2013         | 2012         |
|  | (Amounts in thousands, except per share data) |              |              |              |              |
| <b>Income Data:</b>                    |   |              |              |              |              |
| Net premiums earned                    | \$3,131,773                                   | \$ 2,957,897 | \$ 2,796,195 | \$ 2,698,187 | \$ 2,574,920 |
| Net investment income                  | 121,871                                       | 126,299      | 125,723      | 124,538      | 131,896      |
| Net realized investment (losses) gains | (34,255 )                                     | ( 83,807 )   | 81,184       | (11,422 )    | 66,380       |
| Other                                  | 8,294   | 8,911        | 8,671        | 9,738        | 10,174       |
| Total revenues                         | 3,227,683                                     | 3,009,300    | 3,011,773    | 2,821,041    | 2,783,370    |
| Losses and loss adjustment expenses    | 2,355,138                                     | 2,145,495    | 1,986,122    | 1,962,690    | 1,961,448    |
| Policy acquisition costs               | 562,545                                       | 539,231      | 526,208      | 505,517      | 477,788      |
| Other operating expenses               | 235,314                                       | 250,839      | 249,381      | 219,478      | 207,281      |
| Interest                               | 3,962   | 3,168        | 2,637        | 1,260        | 1,543        |
| Total expenses                         | 3,156,959                                     | 2,938,733    | 2,764,348    | 2,688,945    | 2,648,060    |
| Income before income taxes             | 70,724  | 70,567       | 247,425      | 132,096      | 135,310      |
| Income tax (benefit) expense           | (2,320 )                                      | (3,912 )     | 69,476       | 19,953       | 18,399       |
| Net income                             | \$73,044                                      | \$ 74,479    | \$ 177,949   | \$ 112,143   | \$ 116,911   |
| <b>Per Share Data:</b>                 |   |              |              |              |              |
| Basic earnings per share               | \$1.32  | \$ 1.35      | \$ 3.23      | \$ 2.04      | \$ 2.13      |
| Diluted earnings per share             | \$1.32  | \$ 1.35      | \$ 3.23      | \$ 2.04      | \$ 2.13      |
| Dividends paid per share               | \$2.4825                                      | \$ 2.4725    | \$ 2.4625    | \$ 2.4525    | \$ 2.4425    |

|   | December 31,                                  |              |              |              |              |
|---|---|--------------|--------------|--------------|--------------|
|   | 2016  | 2015         | 2014         | 2013         | 2012         |
|   | (Amounts in thousands, except per share data) |              |              |              |              |
| <b>Balance Sheet Data:</b>                |   |              |              |              |              |
| Total investments                         | \$3,547,560                                   | \$ 3,380,642 | \$ 3,403,822 | \$ 3,158,312 | \$ 3,180,095 |
| Total assets                              | 4,788,718                                     | 4,628,645    | 4,600,289    | 4,315,181    | 4,189,686    |
| Loss and loss adjustment expense reserves | 1,290,248                                     | 1,146,688    | 1,091,797    | 1,038,984    | 1,036,123    |
| Unearned premiums                         | 1,074,437                                     | 1,049,314    | 999,798      | 953,527      | 920,429      |
| Notes payable                             | 320,000                                       | 290,000      | 290,000      | 190,000      | 140,000      |
| Shareholders' equity                      | 1,752,402                                     | 1,820,885    | 1,875,446    | 1,822,486    | 1,842,497    |
| Book value per share                      | 31.70   | 33.01        | 34.02        | 33.15        | 33.55        |

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Cautionary Statements

Certain statements in this Annual Report on Form 10-K or in other materials the Company has filed or will file with the SEC (as well as information included in oral statements or other written statements made or to be made by the Company) contain or may contain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may address, among other things, the Company's strategy for growth, business development, regulatory approvals, market position, expenditures, financial results, and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company's actual business, prospects, and results of operations to differ materially from the historical information contained in this Annual Report on Form 10-K and from those that may be expressed or implied by the forward-looking statements contained in this Annual Report on Form 10-K and in other reports or public statements made by the Company.

Factors that could cause or contribute to such differences include, among others: the competition in the automobile insurance markets in California and the other states in which the Company operates; the cyclical and generally competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserves or other estimates; the accuracy and adequacy of the Company's pricing methodologies; the Company's success in managing its non-California business; the impact of potential third party "bad-faith" legislation, changes in laws, regulations or new interpretations of existing laws and regulations, tax position challenges by the California Franchise Tax Board ("FTB"), and decisions of courts, regulators and governmental bodies, particularly in California; the Company's ability to obtain and the timing of required regulatory approvals of premium rate changes for insurance policies issued in states where the Company operates; the Company's reliance on independent agents to market and distribute its insurance policies; the investment yields the Company is able to obtain on its investments and the market risks associated with the Company's investment portfolio; the effect government policies may have on market interest rates; uncertainties related to assumptions and projections generally, inflation and changes in economic conditions; changes in driving patterns, automobile technologies and loss trends; acts of war and terrorist activities; court decisions, trends in litigation, and health care and automobile repair costs; adverse weather conditions or natural disasters, including those which may be related to climate change, in the markets served by the Company; the stability of the Company's information technology systems and the ability of the Company to execute on its information technology initiatives; the Company's ability to realize deferred tax assets or to hold certain securities with current loss positions to recovery or maturity; and other risks and uncertainties, including but not limited to those discussed in Part I, Item 1A. "Risk Factors" of this Annual Report on Form 10-K or that are otherwise described or updated from time to time in the Company's SEC filings, all of which are difficult to predict and many of which are beyond the Company's control. GAAP prescribes when a company may reserve for particular risks including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods.

From time to time, forward-looking statements are also included in the Company's quarterly reports on Form 10-Q and current reports on Form 8-K, in press releases, in presentations, on its web site, and in other materials released to the public. The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K or, in the case of any document the Company incorporates by reference, any other report filed with the SEC or any other public statement made by the Company, the date of the document, report or statement. Investors should also understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company's forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially

from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements.

## OVERVIEW

### A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of weather and natural disasters on losses, general economic conditions, the general regulatory environment in states in which an insurer operates, state regulation of insurance including premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty insurance industry has been highly cyclical, with periods of high premium rates and shortages



of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a significant impact on the Company's ability to grow and retain business.

The Company is headquartered in Los Angeles, California and writes primarily personal automobile lines of business selling policies through a network of independent agents, 100% owned insurance agents and direct channels, in 11 states: Arizona, California, Florida, Georgia, Illinois, Nevada, New Jersey, New York, Oklahoma, Texas, and Virginia. The Company also offers homeowners, commercial automobile, commercial property, mechanical breakdown, fire, and umbrella insurance. Private passenger automobile lines of insurance business accounted for 77.3% of the \$3.2 billion of the Company's direct premiums written in 2016, and 84% of the private passenger automobile premiums were written in California.

The Company was unable to profitably grow its business in Michigan and Pennsylvania since it began writing insurance in those states in 2004. Michigan and Pennsylvania combined net premiums earned were \$15.4 million and \$18.6 million in 2015 and 2014, respectively, and combined ratios were 137% and 130% in 2015 and 2014, respectively. During the second quarter of 2016, the Company implemented an exit plan to focus resources on other states with better opportunities for sustainable growth, and with the approval of the regulators in Michigan and Pennsylvania, the Company ceased accepting new business in those states in May 2016. The Company expects to complete the run-off of its Michigan and Pennsylvania operations in 2017.

In line with the goal of improving operating efficiencies outside California and overall long-term profitability, the Company restructured its claims operations in states outside of California resulting in a workforce reduction of approximately 100 employees, primarily in the Company's New Jersey and Florida branch offices. As a result, during the second quarter of 2016, the Company recorded a charge, primarily in loss and loss adjustment expenses, of approximately \$2 million for employee termination costs.

This section discusses some of the relevant factors that management considers in evaluating the Company's performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management's discussion and analysis, the Company's consolidated financial statements and notes thereto, and all other items contained within this Annual Report on Form 10-K.

#### 2016 Financial Performance Summary

The Company's net income for the year ended December 31, 2016 decreased to \$73.0 million, or \$1.32 per diluted share, from \$74.5 million, or \$1.35 per diluted share, for the same period in 2015. Included in net income is \$121.9 million of pre-tax investment income that was generated during 2016 on a portfolio of \$3.5 billion at fair value at December 31, 2016, compared to \$126.3 million of pre-tax investment income that was generated during 2015 on a portfolio of \$3.4 billion at fair value at December 31, 2015. Also included in net income are net realized investment losses of \$34.3 million and \$83.8 million in 2016 and 2015, respectively.

During 2016, the Company continued its marketing efforts to enhance name recognition and lead generation. The Company believes that its marketing efforts, combined with its ability to maintain relatively low prices and a strong reputation, make the Company competitive in California and in other states.

The Company believes its thorough underwriting process gives it an advantage over competitors. The Company's agent relationships and underwriting and claims processes are its most important competitive advantages.

The Company's operating results and growth have allowed it to consistently generate positive cash flow from operations, which was approximately \$287 million and \$190 million in 2016 and 2015, respectively. Cash flow from operations has been used to pay shareholder dividends and help support growth.

#### Economic and Industry Wide Factors

**Regulatory Uncertainty**—The insurance industry is subject to strict state regulation and oversight and is governed by the laws of each state in which each insurance company operates. State regulators generally have substantial power and authority over insurance companies including, in some states, approving rate changes and rating factors, and

establishing minimum capital and surplus requirements. In many states, insurance commissioners may emphasize different agendas or interpret existing regulations differently than previous commissioners. There is no certainty that current or future regulations and the interpretation of those regulations by insurance commissioners and the courts will not have an adverse impact on the Company.

Cost Uncertainty—Because insurance companies pay claims after premiums are collected, the ultimate cost of an insurance policy is not known until well after the policy revenues are earned. Consequently, significant assumptions are made when establishing insurance rates and loss reserves. While insurance companies use sophisticated models and experienced actuaries to assist in setting rates and establishing loss reserves, there can be no assurance that current

rates or current reserve estimates will be adequate. Furthermore, there can be no assurance that insurance regulators will approve rate increases when the Company's actuarial analyses indicate that they are needed.

**Economic Conditions**—Many businesses are experiencing the effects of uncertain conditions in the global economy and capital markets, reduced consumer spending and confidence, and continued volatility, which could adversely impact the Company's financial condition, results of operations, and liquidity. Further, volatility in global capital markets could adversely affect the Company's investment portfolio. The Company is unable to predict the impact of current and future global economic conditions on the United States, and California, where the majority of the Company's business is produced.

**Inflation**—The largest cost component for automobile insurers is losses, which include medical, replacement automobile parts, and labor costs. There can be significant variation in the overall increases in medical cost inflation, and it is often a year or more after the respective fiscal period ends before sufficient claims have closed for the inflation rate to be known with a reasonable degree of certainty. Therefore, it can be difficult to establish reserves and set premium rates, particularly when actual inflation rates may be higher or lower than anticipated. The Company expects the labor costs to repair automobiles to increase at a higher rate in 2017 than in 2016.

**Loss Frequency**—Another component of overall loss costs is loss frequency, which is the number of claims per risk insured. Loss frequency trends are affected by many factors such as fuel prices, the economy, the prevalence of distracted driving and collision avoidance and other technology in vehicles. Loss frequency generally increased at a modest rate in 2016.

**Underwriting Cycle and Competition**—The property and casualty insurance industry is highly cyclical, with alternating hard and soft market conditions. The Company has historically seen significant premium growth during hard market conditions. The Company believes that the market is hardening with carriers generally raising rates, although this also depends on individual state profitability and the carriers' growth appetite.

#### Technology

The Company implemented Guidewire's InsuranceSuite in 2010, which is a widely adopted industry software leader. By the end of 2016, Guidewire's products have been deployed in most of the states and lines of business in which the Company operates. There have been numerous enhancements to make Guidewire's products easier and more intuitive for internal and external users. The Company also has ongoing initiatives to improve agent and customer facing portals including mobile and web platforms.

#### B. Regulatory and Legal Matters

The process for implementing rate changes varies by state. For more detailed information related to insurance rate approval, see "Item 1. Business—Regulation."

During 2016, the Company implemented rate changes in twelve states. In California, the following rate increases were implemented or filed for DOI approval:

In February, the California DOI approved a 5.0% rate increase on MIC's private passenger automobile line of insurance business, which represented approximately 50% of the total Company's net premiums earned in 2016. This rate increase was implemented in March 2016.

In April 2016, the California DOI approved a 6.9% rate increase on CAIC's private passenger automobile line of insurance business, which represented approximately 14% of the Company's total net premiums earned in 2016. This rate increase was implemented in June 2016.

In July 2016, CAIC filed for an additional 6.9% rate increase in its private passenger automobile line of business and is awaiting California DOI approval.

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, "2004 NNC") alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer's insurance broker. The California DOI sought to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker fee, to impose a penalty for each policy on which the Company allegedly used a misleading advertisement, and to suspend certificates of authority for a period of one year.

In January 2012, the administrative law judge bifurcated the 2004 NNC between (a) the California DOI's order to show cause (the "OSC"), in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance (the "NNC"), in which the California DOI asserts the unlawful rate allegations. In February 2012, the administrative law judge ("ALJ") submitted a proposed decision dismissing the NNC, but the Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior

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Court in April 2012, and the Commissioner responded with a demurrer. Following a hearing, the Superior Court sustained the Commissioner's demurrer, based on the Company's failure to exhaust its administrative remedies, and the Company appealed. The Court of Appeal affirmed the Superior Court's ruling that the Company was required to exhaust its administrative remedies, but expressly preserved for later appeal the legal basis for the ALJ's dismissal: violation of the Company's due process rights. Following an evidentiary hearing in April 2013, post-hearing briefs, and an unsuccessful mediation, the ALJ closed the evidentiary record on April 30, 2014. Although a proposed decision was to be submitted to the Commissioner on or before June 30, 2014, after which the Commissioner would have 100 days to accept, reject or modify the proposed decision, the proposed decision was not submitted until December 8, 2014. On January 7, 2015, the Commissioner adopted the ALJ's proposed decision, which became the Commissioner's adopted order (the "Order"). The decision and Order found that from the period July 1, 1996, through 2006, the Company's "brokers" were actually operating as "de facto agents" and that the charging of "broker fees" by these producers constituted the charging of "premium" in excess of the Company's approved rates, and assessed a civil penalty in the amount of \$27.6 million against the Company. On February 9, 2015, the Company filed a Writ of Administrative Mandamus and Complaint for Declaratory Relief (the "Writ") in the Orange County Superior Court seeking, among other things, to require the Commissioner to vacate the Order, to stay the Order while the Superior Court action is pending, and to judicially declare as invalid the Commissioner's interpretation of certain provisions of the California Insurance Code. Subsequent to the filing of the Writ, a consumer group petitioned and was granted the right to intervene in the Superior Court action. The Court did not order a stay, and the \$27.6 million assessed penalty was paid in March 2015. The Company filed an amended Writ on September 11, 2015, adding an explicit request for a refund of the penalty, with interest.

On August 12, 2016, the Superior Court issued its ruling on the Writ, for the most part granting the relief sought by the Company. The Superior Court found that the Commissioner and the California DOI did commit due process violations, but declined to dismiss the case on those grounds. The Superior Court also agreed with the Company that the broker fees at issue were not premium, and that the penalties imposed by the Commissioner were improper, and therefore vacated the Order imposing the penalty. The Superior Court entered final judgment on November 17, 2016, issuing a writ requiring the Commissioner to refund the entire penalty amount within 120 days, plus prejudgment interest at the statutory rate of 7%. The Company has filed a motion with the ALJ to dismiss the false advertising OSC portion of the NNC based on the Superior Court's findings and legal reasoning. On January 12, 2017, the Commissioner filed a notice of appeal of the Superior Court's judgment entered on November 17, 2016. Since the matter has been appealed, the Company has not yet recognized in the consolidated financial statements the vacation of the Commissioner's Order or established a receivable for the refund of the \$27.6 million penalty plus any related interest owed.

The Company has also accrued a liability for the estimated cost to continue to defend itself in the false advertising OSC. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the false advertising OSC will be material to its financial position.

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see "Critical Accounting Policies and Estimates" below and Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For material loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions

is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see Note 17. Commitments and Contingencies—Litigation of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

### C. Critical Accounting Policies and Estimates

#### Loss and Loss Adjustment Expense Reserves ("Loss Reserves")

Preparation of the Company's consolidated financial statements requires management's judgment and estimates. The most significant is the estimate of loss reserves. Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the loss reserve that is required. A key assumption in estimating loss reserves is the degree to which the historical data used to analyze reserves will be predictive of ultimate claim costs on incurred claims. Changes in the regulatory and legal environments, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact this assumption. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail liability claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims.

The Company calculates a loss reserve point estimate rather than a range. There is inherent uncertainty with estimates and this is particularly true with loss reserve estimates. This uncertainty comes from many factors which may include changes in claims reporting and settlement patterns, changes in the regulatory and legal environments, uncertainty over inflation rates, and uncertainty for unknown items. The Company does not make specific provisions for these uncertainties, rather it considers them in establishing its loss reserve by looking at historical patterns and trends and projecting these out to current loss reserves. The underlying factors and assumptions that serve as the basis for preparing the loss reserve estimate include paid and incurred loss development factors, expected average costs per claim, inflation trends, expected loss ratios, industry data, and other relevant information.

The Company also engages independent actuarial consultants to review the Company's loss reserves and to provide the annual actuarial opinions required under state statutory accounting requirements. The Company analyzes loss reserves quarterly primarily using the incurred loss, paid loss, average severity coupled with the claim count development methods, and the generalized linear model ("GLM") described below. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of insurance business or coverage within a line of insurance business. The Company may also evaluate qualitative factors such as known changes in laws or legal rulings that could affect claims handling or other external environmental factors or internal factors that could affect the settlement of claims. When establishing the loss reserve, the Company generally analyzes the results from all of the methods used rather than relying on a single method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves. The incurred loss method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of insurance business which have a long operating history.

The paid loss method analyzes historical payment patterns to estimate the amount of losses yet to be paid.

The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The average severity method coupled with the claim count development method provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing loss reserves. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The GLM determines an average severity for each percentile of claims that have been closed as a percentage of estimated ultimate claims. The average severities are applied to open claims to estimate the amount of losses yet to be paid. The GLM utilizes operational time, determined as a percentile of claims closed rather than a finite calendar period, which neutralizes the effect of changes in the timing of claims handling.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company generally determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on loss reserves established by adjusters and average losses on previous similar catastrophes.



There are many factors that can cause variability between the ultimate expected loss and the actual developed loss. While there are certainly other factors, the Company believes that the following three items tend to create the most variability between expected losses and actual losses.

(1) Inflation

For the Company's California automobile lines of insurance business, total reserves are comprised of the following:

• BI reserves—approximately 75% of total reserves

• Material damage ("MD") reserves, including collision and comprehensive property damage—approximately 10% of total reserves

• Loss adjustment expense reserves—approximately 15% of total reserves.

Loss development on MD reserves is generally insignificant because MD claims are generally settled in a shorter period than BI claims. The majority of the loss adjustment expense reserves are estimated costs to defend BI claims, which tend to require longer periods of time to settle as compared to MD claims.

BI loss reserves are generally the most difficult to estimate because they take longer to close than other coverages. BI coverage in the Company's policies includes injuries sustained by any person other than the insured, except in the case of uninsured or underinsured motorist BI coverage, which covers damages to the insured for BI caused by uninsured or underinsured motorists. BI payments are primarily for medical costs and general damages.

The following table presents the typical closure patterns of BI claims in the Company's California personal automobile insurance coverage:

|   | % of Total    |              |
|---|---------------|--------------|
|   | Claims Closed | Dollars Paid |
| BI claims closed in the accident year reported                | 40%           | 13%          |
| BI claims closed one year after the accident year reported    | 80%           | 57%          |
| BI claims closed two years after the accident year reported   | 95%           | 82%          |
| BI claims closed three years after the accident year reported | 98%           | 93%          |

BI claims closed in the accident year reported are generally the smaller and less complex claims that settle for approximately \$3,500 to \$4,000, on average, whereas the total average settlement, once all claims are closed in a particular accident year, is approximately \$10,000 to \$12,000. The Company creates incurred and paid loss triangles to estimate ultimate losses utilizing historical payment and reserving patterns and evaluates the results of this analysis against its frequency and severity analysis to establish BI loss reserves. The Company adjusts development factors to account for inflation trends it sees in loss severity. As a larger proportion of claims from an accident year are settled, there emerges a higher degree of certainty for the loss reserves established for that accident year. Consequently, there is generally a decreasing likelihood of loss reserve development on any particular accident year, as those periods age. At December 31, 2016, the accident years that are most likely to develop are the 2014 through 2016 accident years; however, it is possible that older accident years could develop as well.

In general, the Company expects that historical claims trends will continue with costs tending to increase, which is generally consistent with historical data, and therefore the Company believes that it is reasonable to expect inflation to continue. Many potential factors can affect the BI inflation rate, including changes in claims handling process, changes in statutes and regulations, the number of litigated files, increased use of medical procedures such as MRIs and epidural injections, general economic factors, timeliness of claims adjudication, vehicle safety, weather patterns, and gasoline prices, among other factors; however, the magnitude of the impact of such factors on the inflation rate is unknown.

The Company believes that it is reasonably possible that the California automobile BI severity could vary from recorded amounts by as much as 10%, 5%, and 3% for 2016, 2015, and 2014 accident years, respectively.

During the years 2012 through 2016, the changes in the loss severity amounts for the three preceding accident years from the prior year amounts (BI severity variance from prior year) have ranged as follows:

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|                                   | High | Low    |
|-----------------------------------|------|--------|
| Immediate preceding accident year | 7.0% | (3.1)% |
| Second preceding accident year    | 2.5% | (1.3)% |
| Third preceding accident year     | 1.5% | 0.3%   |

The following table presents the effects on the California automobile BI loss reserves for the 2016, 2015, and 2014 accident years based on possible variations in the severity recorded; however, the variation could be more or less than these amounts.

California Automobile Bodily Injury Inflation Reserve Sensitivity Analysis

| Accident Year                                   | Number of Claims Expected (1) | Actual Recorded Severity at 12/31/16 (1) | Implied Inflation Rate Recorded (2) |              | (A) Pro-forma severity if actual severity is lower by 10% for 2016, 5% for 2015, and 3% for 2014 | (B) Pro-forma severity if actual severity is higher by 10% for 2016, 5% for 2015, and 3% for 2014 | Favorable loss development if actual severity is less than recorded (Column A) | Unfavorable loss development if actual severity is more than recorded (Column B) |
|---|-------------------------------|--|-------------------------------------|--------------|--|---|--|--|
|   |                               |  |                                     |              |  |   |  |  |
| 2016  | 29,698                        | (3)\$ 11,903                             | (3)16.5 %                           | (3)\$ 10,713 | \$ 13,093  | \$ 35,341,000   | \$ (35,341,000 )   |  |
| 2015  | 32,216                        | \$ 10,216                                | 3.7 %                               | \$ 9,705     | \$ 10,727  | \$ 16,462,000   | \$ (16,462,000 )   |  |
| 2014  | 32,197                        | \$ 9,855                                 | -1.0 %                              | \$ 9,559     | \$ 10,151  | \$ 9,530,000  | \$ (9,530,000 )  |  |
| 2013  | 31,263                        | \$ 9,957                                 | —                                   | \$ —         | \$ —   | \$ —  | \$ —   |  |
| Total Loss Development— Favorable (Unfavorable) |                               |  |                                     |              |  |   | \$ 61,333,000  | \$ (61,333,000 )   |

(1) The number of claims expected and the actual recorded severity for the 2013 through 2015 accident years are not comparable with the amounts previously reported on this table in prior filings. These amounts have been restated to be on a consistent reporting basis with the 2016 accident year.

(2) Implied inflation rate is calculated by dividing the difference between the current and prior year actual recorded severity by the prior year actual recorded severity.

(3) During 2016, the Company implemented a claims strategy that reduced the number of small dollar settlements offered shortly after the claims were reported. This strategy reduced the total number of claims expected, which had the effect of increasing the actual recorded severity across the total claims population. There were fewer small dollar claims in the calculation of actual recorded severity for the 2016 accident year compared to prior accident years. Consequently, the 16.5% increase in actual recorded severity is skewed upward due to this strategy change. Had, for example, the number of claims expected for the 2016 accident year of 29,698 been equal to the number of claims expected for the 2015 accident year of 32,216, the change in actual recorded severity for the 2016 accident year would have been 7.4%.

(2) Claim Count Development

The Company generally estimates ultimate claim counts for an accident period based on development of claim counts in prior accident periods. For California automobile BI claims, the Company's experience indicates that approximately 4% to 7% additional claims would be reported in the year subsequent to an accident year. However, such late reported claims could be more or less than the Company's expectations. Typically, almost every claim is reported within one year following the end of an accident year and at that point the Company has a high degree of certainty as to the ultimate claim count.

There are many other potential factors that can affect the number of claims reported after an accident period ends. These factors include changes in weather patterns, a change in the number of litigated files, the number of automobiles insured, and whether the last day of the accident period falls on a weekday or a weekend. However, the Company is unable to determine which, if any, of the factors actually impact the number of claims reported and, if so, by what magnitude.

At December 31, 2016, there were 27,896 BI claims reported for the 2016 accident year and the Company estimates that these are expected to ultimately grow by approximately 6.5%. The Company believes that while actual development in recent years has ranged approximately from 4% to 7%, it is reasonable to expect that the range could be as great as between 0% and 10%. Actual development may be more or less than the expected range.

The following table presents the effects on loss development of different claim count within the broader possible range at December 31, 2016:

California Automobile Bodily Injury Claim Count Reserve Sensitivity Analysis

| 2016 Accident Year                             | Claims Reported | Amount Recorded at 12/31/16 at 6.5% Claim Count Development | Total Expected Amount If Claim Count Development is 0% | Total Expected Amount If Claim Count Development is 10% |
|--|-----------------|---|--|---|
| Claim count                                    | 27,896          | 29,698  | 27,896   | 30,686  |
| Approximate average cost per claim             | Not meaningful  | \$ 11,903   | \$ 11,903  | \$ 11,903   |
| Total dollars                                  | Not meaningful  | \$ 353,495,000  | \$ 332,046,000   | \$ 365,255,000  |
| Total Loss Development—Favorable (Unfavorable) |                 |   | \$ 21,449,000  | \$ (11,760,000)   |

(3) Unexpected Losses From Older Accident Periods

Unexpected losses are generally not provided for in the current loss reserve because they are not known or expected and tend to be unquantifiable. Once known, the Company establishes a provision for the losses, but it is not possible to provide any meaningful sensitivity analysis as to the potential size of any unexpected losses. These losses can be caused by many factors, including unexpected legal interpretations of coverage, ineffective claims handling, regulations extending claims reporting periods, assumption of unexpected or unknown risks, adverse court decisions as well as many unknown factors. During 2016, the Company incurred losses totaling approximately \$10 million on three separate large claims from accident periods prior to 2013. These were related to either adverse legal outcomes or provisions made for the likelihood of adverse legal outcomes.

Unexpected losses are fairly infrequent but can have a large impact on the Company's losses. To mitigate this risk, the Company has established claims handling and review procedures. However, it is still possible that these procedures will not prove entirely effective, and the Company may have material unexpected losses in future periods. It is also possible that the Company has not identified and established a sufficient loss reserve for all material unexpected losses occurring in the older accident years, even though a comprehensive claims file review was undertaken. The Company may experience additional development on these loss reserves.

Discussion of losses and loss reserves and prior period loss development at December 31, 2016

At December 31, 2016 and 2015, the Company recorded its point estimate of approximately \$1.29 billion and \$1.15 billion, respectively, in loss and loss adjustment expense reserves, which include approximately \$534.8 million and \$440.7 million, respectively, of incurred-but-not-reported liabilities ("IBNR"). IBNR includes estimates, based upon past experience, of ultimate developed costs, which may differ from case estimates, unreported claims that occurred on or prior to December 31, 2016 and 2015, and estimated future payments for reopened claims. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company evaluates its loss reserves quarterly. When management determines that the estimated ultimate claim cost requires a decrease for previously reported accident years, favorable development occurs and a reduction in losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, unfavorable development occurs and an increase in losses and loss adjustment expenses is reported in the current period. For 2016, the Company reported unfavorable development of approximately \$85 million on the 2015 and prior accident years' loss and loss adjustment expense reserves, which at December 31, 2015 totaled approximately \$1.15 billion. The unfavorable development in 2016 was primarily from the California and Florida automobile lines of business.

During 2016, the Company recorded catastrophe losses of approximately \$27 million resulting primarily from severe storms outside of California and rainstorms in California.

Investments

The Company's fixed maturity and equity investments are classified as "trading" and carried at fair value as required when applying the fair value option, with changes in fair value reflected in net realized investment gains or losses in the consolidated statements of operations. The majority of equity holdings, including non-redeemable preferred stocks, are actively traded on national exchanges or trading markets, and are valued at the last transaction price on the balance sheet dates.

#### Fair Value of Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, receivables, total return swaps, accounts payable, options sold, and secured and unsecured notes payable. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Due to their short-term maturity, the carrying values of receivables and accounts payable approximate their fair values. All investments are carried on the consolidated balance sheets at fair value, as described in Note 2. Fair Value of Financial Instruments, of the Notes to Consolidated Financial Statements in Item 8. "Financial Statements and Supplementary Data."

The Company's financial instruments include securities issued by the U.S. government and its agencies, securities issued by states and municipal governments and agencies, certain corporate and other debt securities, equity securities, and exchange traded funds. 99.7% of the fair value of these financial instruments held at December 31, 2016 is based on observable market prices, observable pricing parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary by financial instrument. Observable market prices and pricing parameters of a financial instrument, or a related financial instrument, are used to derive a price without requiring significant judgment.

The Company may hold or acquire financial instruments that lack observable market prices or pricing parameters because they are less actively traded currently or in future periods. The fair value of such instruments is determined using techniques appropriate for each particular financial instrument. These techniques may involve some degree of judgment. The price transparency of the particular financial instrument will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including the type of financial instrument, whether it is a new financial instrument and not yet established in the marketplace, and the characteristics particular to the transaction. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, financial instruments that are thinly traded or not quoted will generally have diminished price transparency. Even in normally active markets, the price transparency for actively quoted financial instruments may be reduced during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market makers willing to purchase and sell a financial instrument provides a source of transparency for products that otherwise are not actively quoted. For a further discussion, see Note 4. Fair Value Measurement, of the Notes to Consolidated Financial Statements in Item 8. "Financial Statements and Supplementary Data."

#### Income Taxes

At December 31, 2016, the Company's deferred income taxes were in a net asset position mainly due to deferred tax assets generated by unearned premiums, AMT credit carryforwards, expense accruals and loss reserve discounting. These deferred tax assets were substantially offset by deferred tax liabilities resulting from deferred acquisition costs and unrealized gains on securities held. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Management's recoverability assessment of the Company's deferred tax assets which are ordinary in character takes into consideration the Company's strong history of generating ordinary taxable income and a reasonable expectation that it will continue to generate ordinary taxable income in the future. Further, the Company has the capacity to recoup its ordinary deferred tax assets through tax loss carryback claims for taxes paid in prior years. Finally, the Company has various deferred tax liabilities that represent sources of future ordinary taxable income.

Management's recoverability assessment with regard to its capital deferred tax assets is based on estimates of anticipated capital gains, tax-planning strategies available to generate future taxable capital gains, and the Company's capacity to absorb capital losses carried back to prior years, each of which would contribute to the realization of deferred tax benefits. The Company has significant unrealized gains in its investment portfolio that could be realized through asset dispositions, at management's discretion. In addition, the Company expects to hold certain debt

securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a portion of the unrealized loss positions at period-end, are fully realizable at maturity. Management believes its long-term time horizon for holding these securities allows it to avoid any forced sales prior to maturity. Further, the Company has the capability to generate additional realized capital gains by entering into sale-leaseback transactions using one or more of its appreciated real estate holdings. Finally, the Company has the capacity to recoup capital deferred tax assets through tax capital loss carryback claims for taxes paid within permitted carryback periods.

The Company has the capability to implement tax planning strategies as it has a steady history of generating positive cash flow from operations and believes that its cash flow needs can be met in future periods without the forced sale of its investments. This capability assists management in controlling the timing and amount of realized losses generated during future periods. By



prudent utilization of some or all of these strategies, management has the intent and believes that it has the ability to generate capital gains and minimize tax losses in a manner sufficient to avoid losing the benefits of its deferred tax assets. Management will continue to assess the need for a valuation allowance on a quarterly basis. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

The Company's effective income tax rate can be affected by several factors. These generally include tax-exempt investment income, nondeductible expenses, and periodically, non-routine tax items such as adjustments to unrecognized tax benefits related to tax uncertainties. The effective tax rate was (3.3)% for 2016, compared to (5.5)% for 2015. The increase in the effective tax rate was mainly due to an increase in liability for uncertain tax positions in 2016 combined with a decrease in liability for uncertain tax positions in 2015. The Company's effective tax rate for the years ended December 31, 2016 and 2015 was lower than the statutory tax rate primarily as a result of tax-exempt investment income earned.

#### Contingent Liabilities

The Company has known, and may have unknown, potential liabilities which include claims, assessments, lawsuits, or regulatory fines and penalties relating to the Company's business. The Company continually evaluates these potential liabilities and accrues for them and/or discloses them in the notes to the consolidated financial statements where required. The Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows. See "Regulatory and Legal Matters" above and Note 17. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

#### Premiums

The Company's insurance premiums are recognized as income ratably over the term of the policies and in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the consolidated balance sheets and are computed monthly on a pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs, and maintenance costs partially offset by investment income to related unearned premiums. To the extent that any of the Company's lines of insurance business become unprofitable, a premium deficiency reserve may be required.

### RESULTS OF OPERATIONS

Year Ended December 31, 2016 Compared to Year Ended December 31, 2015

#### Revenues

Net premiums written and net premiums earned in 2016 increased 5.2% and 5.9%, respectively, from 2015. The increase in net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile line of insurance business and growth in the number of homeowners and commercial automobile policies written in California.

Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels. Net premiums earned, the most directly comparable GAAP measure, represents the portion of net premiums written that is recognized as revenue in the financial statements for the period presented and earned on a pro-rata basis over the term of the policies.

The following is a reconciliation of total net premiums earned to net premiums written:

Year Ended December  
31,

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|                                 | 2016                   | 2015        |
|---------------------------------|------------------------|-------------|
|                                 | (Amounts in thousands) |             |
| Net premiums earned             | \$3,131,773            | \$2,957,897 |
| Change in net unearned premiums | 24,015                 | 41,495      |
| Net premiums written            | \$3,155,788            | \$2,999,392 |

## Expenses

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table presents the Insurance Companies' consolidated loss, expense, and combined ratios determined in accordance with GAAP:

|                | Year Ended   |       |
|----------------|--------------|-------|
|                | December 31, |       |
|                | 2016         | 2015  |
| Loss ratio     | 75.2 %       | 72.5% |
| Expense ratio  | 25.5 %       | 26.7% |
| Combined ratio | 100.7%       | 99.2% |

Loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The Company's loss ratio was affected by unfavorable development of approximately \$85 million and \$13 million on prior accident years' loss and loss adjustment expense reserves for the years ended December 31, 2016 and 2015, respectively. The unfavorable development in 2016 was primarily from the California and Florida automobile lines of business. The unfavorable development in 2015 was primarily from the California homeowners and automobile lines of business outside of California, which was partially offset by favorable development in the California personal automobile line of business. The 2016 loss ratio was also negatively impacted by a total of \$27 million of catastrophe losses mostly due to severe storms outside of California and rainstorms in California. The 2015 loss ratio was also negatively impacted by a total of \$19 million of catastrophe losses mostly due to severe storms outside of California, and rainstorms and wildfires in California. Excluding the effect of estimated prior periods' loss development and catastrophe losses, the loss ratio for the year ended December 31, 2016 was 71.6%, which is comparable to 71.5% for the year ended December 31, 2015.

Expense ratio is calculated by dividing the sum of policy acquisition costs plus other operating expenses by net premiums earned. The lower expense ratio for the year ended December 31, 2016 was primarily attributable to lower advertising expenses and lower overall compensation costs, including bonuses, compared to the year ended December 31, 2015.

Combined ratio is equal to loss ratio plus expense ratio and is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results; a combined ratio over 100% generally reflects unprofitable underwriting results.

Income tax benefit was \$2.3 million and \$3.9 million for the years ended December 31, 2016 and 2015, respectively. The \$1.6 million decrease in income tax benefit was mainly due to an increase in liability for uncertain tax positions in 2016 combined with a decrease in liability for uncertain tax positions in 2015.

## Investments

The following table presents the investment results of the Company:

|  | Year Ended December 31, |             |
|--|-------------------------|-------------|
|  | 2016                    | 2015        |
|  | (Amounts in thousands)  |             |
| Average invested assets at cost <sup>(1)</sup>     | \$3,390,769             | \$3,293,948 |
| Net investment income <sup>(2)</sup>               |                         |             |
| Before income taxes                                | \$121,871               | \$126,299   |
| After income taxes                                 | \$107,140               | \$110,382   |
| Average annual yield on investments <sup>(2)</sup> |                         |             |
| Before income taxes                                | 3.6                     | % 3.8       |
| After income taxes                                 | 3.2                     | % 3.4       |
| Net realized investment losses                     | \$(34,255)              | \$(83,807)  |

- (1) Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each respective period. Net investment income before and after income taxes and average annual yields on investments after income taxes
- (2) decreased slightly, primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments.

The following tables present the components of net realized investment (losses) gains included in net income:

|   | Year Ended December 31, 2016 |                             |            |
|---|------------------------------|-----------------------------|------------|
|   | (Losses) Gains Recognized in |                             |            |
|   | Income                       |                             |            |
|   | Sales                        | Changes<br>in fair<br>value | Total      |
|   | (Amounts in thousands)       |                             |            |
| Net realized investment (losses) gains:     |                              |                             |            |
| Fixed maturity securities <sup>(1)(2)</sup> | \$(15,806)                   | \$(56,584)                  | \$(72,390) |
| Equity securities <sup>(1)(3)</sup>         | (499 )                       | 23,722                      | 23,223     |
| Short-term investments <sup>(1)</sup>       | (524 )                       | 57                          | (467 )     |
| Total return swaps                          | 107                          | 11,426                      | 11,533     |
| Options sold                                | 3,846                        | —                           | 3,846      |
| Total                                       | \$(12,876)                   | \$(21,379)                  | \$(34,255) |
|   | Year Ended December 31, 2015 |                             |            |
|   | (Losses) Gains Recognized in |                             |            |
|   | Income                       |                             |            |
|   | Sales                        | Changes<br>in fair<br>value | Total      |
|   | (Amounts in thousands)       |                             |            |
| Net realized investment (losses) gains:     |                              |                             |            |
| Fixed maturity securities <sup>(1)(2)</sup> | \$136                        | \$(39,304)                  | \$(39,168) |
| Equity securities <sup>(1)(3)</sup>         | (17,459 )                    | (22,988 )                   | (40,447 )  |
| Short-term investments <sup>(1)</sup>       | (1,396 )                     | 561                         | (835 )     |
| Total return swaps                          | 1,062                        | (7,500 )                    | (6,438 )   |
| Options sold                                | 3,021                        | 60                          | 3,081      |
| Total                                       | \$(14,636)                   | \$(69,171)                  | \$(83,807) |

<sup>(1)</sup> The changes in fair value of the investment portfolio result from the application of the fair value option.

<sup>(2)</sup> The Company's municipal bond holdings represent the majority of the fixed maturity portfolio. The fair values in 2016 and 2015 were adversely affected by the increases in market interest rates.

In 2016, the increases in the fair value of equity securities were primarily due to an overall improvement in the

<sup>(3)</sup> equity markets. In 2015, the decreases in the fair value of equity securities were primarily due to a decline in the value of the Company's holdings in industrial stocks.

#### Net Income

|  | Year Ended                                       |           |
|--|--|-----------|
|  | December 31,                                     |           |
|  | 2016   | 2015      |
|  | (Amounts in thousands,<br>except per share data) |           |
| Net income                                 | \$ 73,044  | \$ 74,479 |
| Basic average shares outstanding           | 55,249   | 55,157    |
| Diluted average shares outstanding         | 55,302   | 55,209    |
| Basic Per Share Data:                      |  |           |
| Net income                                 | \$ 1.32  | \$ 1.35   |
| Net realized investment losses, net of tax | \$(0.40 )  | \$(0.99 ) |
| Diluted Per Share Data:                    |  |           |

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|  |            |            |
|--|------------|------------|
| Net income                                 | \$ 1.32    | \$ 1.35    |
| Net realized investment losses, net of tax | \$ (0.40 ) | \$ (0.99 ) |

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Year Ended December 31, 2015 Compared to Year Ended December 31, 2014

#### Revenues

Net premiums written and net premiums earned in 2015 increased 5.6% and 5.8%, respectively, from 2014. The increase in net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile line of insurance business and growth in the number of homeowner policies written in California and private passenger automobile policies written in several states outside of California.

The following is a reconciliation of total net premiums earned to net premiums written:

|                                 | Year Ended December    |             |
|---------------------------------|------------------------|-------------|
|                                 | 31,                    |             |
|                                 | 2015                   | 2014        |
|                                 | (Amounts in thousands) |             |
| Net premiums earned             | \$2,957,897            | \$2,796,195 |
| Change in net unearned premiums | 41,495                 | 44,727      |
| Net premiums written            | \$2,999,392            | \$2,840,922 |

#### Expenses

The following table presents the Company's consolidated loss, expense, and combined ratios determined in accordance with GAAP:

|                               | Year Ended   |       |
|-------------------------------|--------------|-------|
|                               | December 31, |       |
|                               | 2015         | 2014  |
| Loss ratio                    | 72.5%        | 71.0% |
| Expense ratio                 | 26.7%        | 27.7% |
| Combined ratio <sup>(1)</sup> | 99.2%        | 98.8% |

<sup>(1)</sup> Combined ratio for 2014 does not sum due to rounding.

The Company's loss ratio was affected by unfavorable development of approximately \$13 million and favorable development of approximately \$3 million on prior accident years' loss and loss adjustment expense reserves for the years ended December 31, 2015 and 2014, respectively. The unfavorable development in 2015 was primarily from the California homeowners and automobile lines of business outside of California, which was partially offset by favorable development in the California personal automobile line of business. The favorable development in 2014 was primarily from California personal automobile lines of insurance business partially offset by adverse development in other states. The 2015 loss ratio was also negatively impacted by a total of \$19 million of catastrophe losses mostly due to severe storms outside of California, and rainstorms and wildfires in California. The 2014 loss ratio was also negatively impacted by a total of \$11 million of catastrophe losses mostly due to winter freeze events in the East Coast and homeowners losses in California from severe rainstorms. Excluding the effect of estimated prior periods' loss development and catastrophe losses, the loss ratio was 71.5% and 70.7% for the years ended December 31, 2015 and 2014, respectively. The increase in the adjusted loss ratio was primarily due to higher loss frequency and severity. Excluding the \$27.6 million penalty assessed by the California DOI and accrued by the Company in 2014, the expense ratio would have been 26.8% in 2014 comparable to the expense ratio in 2015. The 2015 expense ratio also included higher advertising expenses and lower average commissions paid to agents.

Income tax (benefit) expense was \$(3.9) million and \$69.5 million for the years ended December 31, 2015 and 2014, respectively. The \$73.4 million decrease in income tax expense to an income tax benefit was primarily due to a \$176.9 million reduction in total pre-tax income, while tax-exempt investment income, a component of total pre-tax income, remained relatively consistent compared to the same period in 2014. The decrease in pre-tax income was primarily due to a change in net realized investment gains of \$81.2 million in 2014 to net realized investment losses of \$83.8 million in 2015.





Investments

The following table presents the investment results of the Company:

|  | Year Ended December 31, |             |
|--|-------------------------|-------------|
|  | 2015                    | 2014        |
|  | (Amounts in thousands)  |             |
| Average invested assets at cost <sup>(1)</sup>     | \$3,293,948             | \$3,204,592 |
| Net investment income <sup>(2)</sup>               |                         |             |
| Before income taxes                                | \$ 126,299              | \$ 125,723  |
| After income taxes                                 | \$ 110,382              | \$ 111,456  |
| Average annual yield on investments <sup>(2)</sup> |                         |             |
| Before income taxes                                | 3.8                     | % 3.9       |
| After income taxes                                 | 3.4                     | % 3.5       |
| Net realized investment (losses) gains             | \$(83,807 )             | \$81,184    |

(1) Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each respective period.

Net investment income before income taxes increased slightly due to higher average invested asset balances. Net investment income and average annual yields on investments after income taxes decreased slightly primarily due to

(2) the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments, and a higher effective tax rate on investment income due to a greater proportion of taxable investments in 2015 compared to 2014.

The following tables present the components of net realized investment (losses) gains included in net income:

|   | Year Ended December 31, 2015 |                             |            |
|---|------------------------------|-----------------------------|------------|
|   | (Losses) Gains Recognized in |                             |            |
|   | Income                       |                             |            |
|   | Sales                        | Changes<br>in fair<br>value | Total      |
|   | (Amounts in thousands)       |                             |            |
| Net realized investment (losses) gains:     |                              |                             |            |
| Fixed maturity securities <sup>(1)(2)</sup> | \$ 136                       | \$(39,304)                  | \$(39,168) |
| Equity securities <sup>(1)(3)</sup>         | (17,459 )                    | (22,988 )                   | (40,447 )  |
| Short-term investments <sup>(1)</sup>       | (1,396 )                     | 561                         | (835 )     |
| Total return swaps                          | 1,062                        | (7,500 )                    | (6,438 )   |
| Options sold                                | 3,021                        | 60                          | 3,081      |
| Total                                       | \$(14,636)                   | \$(69,171)                  | \$(83,807) |

|   | Year Ended December 31,      |                             |          |
|---|------------------------------|-----------------------------|----------|
|   | 2014                         |                             |          |
|   | Gains (Losses) Recognized in |                             |          |
|   | Income                       |                             |          |
|   | Sales                        | Changes<br>in fair<br>value | Total    |
|   | (Amounts in thousands)       |                             |          |
| Net realized investment gains (losses):     |                              |                             |          |
| Fixed maturity securities <sup>(1)(2)</sup> | \$(2,719 )                   | \$77,208                    | \$74,489 |
| Equity securities <sup>(1)(3)</sup>         | 41,637                       | (32,922 )                   | 8,715    |
| Short-term investments <sup>(1)</sup>       | (1,943 )                     | (527 )                      | (2,470 ) |
| Total return swap                           | 2,706                        | (5,675 )                    | (2,969 ) |

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|              |          |          |          |
|--------------|----------|----------|----------|
| Options sold | 3,394    | 25       | 3,419    |
| Total        | \$43,075 | \$38,109 | \$81,184 |

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- (1) The changes in fair value of the investment portfolio result from the application of the fair value option. The Company's municipal bond holdings represent the majority of the fixed maturity portfolio. The fair values in
- (2) 2015 were adversely affected by the increase in market interest rates in 2015. The fair value increases in 2014 were primarily caused by the overall improvement in the municipal bond market. In 2015, the decreases in the fair value of equity securities were primarily due to a decline in the value of the
- (3) Company's holdings in industrial stocks. Prior to the fourth quarter of 2014, the Company realized gains by selling equity securities. During the fourth quarter of 2014, decreases in the fair value of equity securities were primarily due to a decline in the value of the Company's holdings in energy stocks.

## Net Income

|  | Year Ended                                    |            |
|--|---|------------|
|  | December 31,                                  |            |
|  | 2015  | 2014       |
|  | (Amounts in thousands, except per share data) |            |
| Net income   | \$ 74,479                                     | \$ 177,949 |
| Basic average shares outstanding                   | 55,157  | 55,008     |
| Diluted average shares outstanding                 | 55,209  | 55,020     |
| Basic Per Share Data:                              |   |            |
| Net income   | \$ 1.35                                       | \$ 3.23    |
| Net realized investment gains (losses), net of tax | \$ (0.99 )                                    | \$ 0.95    |
| Diluted Per Share Data:                            |   |            |
| Net income   | \$ 1.35                                       | \$ 3.23    |
| Net realized investment gains (losses), net of tax | \$ (0.99 )                                    | \$ 0.95    |

## LIQUIDITY AND CAPITAL RESOURCES

### A. General

The Company is largely dependent upon dividends received from its insurance subsidiaries to pay debt service costs and to make distributions to its shareholders. Under current insurance law, the Insurance Companies are entitled to pay ordinary dividends of approximately \$144 million in 2017 to Mercury General. The Insurance Companies paid Mercury General ordinary dividends of \$111 million during 2016. As of December 31, 2016, Mercury General had approximately \$137 million in investments and cash that could be utilized to satisfy its direct holding company obligations.

The principal sources of funds for the Insurance Companies are premiums, sales and maturity of invested assets, and dividend and interest income from invested assets. The principal uses of funds for the Insurance Companies are the payment of claims and related expenses, operating expenses, dividends to Mercury General, payment of debt and debt service costs, and the purchase of investments.

### B. Cash Flows

The Company has generated positive cash flow from operations since the public offering of its common stock in November 1985, and does not attempt to match the duration and timing of asset maturities with those of liabilities. Rather, the Company manages its portfolio with a view towards maximizing total return with an emphasis on after-tax income. With combined cash and short-term investments of \$596.0 million at December 31, 2016 as well as \$70 million of credit available on a \$250 million revolving credit facility, the Company believes its cash flow from operations is adequate to satisfy its liquidity requirements without the forced sale of investments. Investment maturities are also available to meet the Company's liquidity needs. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be

sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs or for future business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

Net cash provided by operating activities for the year ended December 31, 2016 was \$287.5 million, an increase of \$97.2 million compared to the year ended December 31, 2015. The increase was primarily due to an increase in premium collections and decreases in income taxes and operating expenses paid, partially offset by higher paid losses, loss adjustment expenses and

policy acquisition costs. Operating expenditures for the year ended December 31, 2015 included the payment of the \$27.6 million penalty assessed by California DOI as discussed in "Regulatory and Legal Matters" above. The Company utilized the cash provided by operating activities during the year ended December 31, 2016 primarily for the payment of dividends to its shareholders and net purchases of investment securities.

The following table presents the estimated fair value of fixed maturity securities at December 31, 2016 by contractual maturity in the next five years.

|  | Fixed Maturity<br>Securities<br>(Amounts in thousands) |
|--|--|
| Due in one year or less                  | \$ 381,189   |
| Due after one year through two years     | 180,164  |
| Due after two years through three years  | 147,746  |
| Due after three years through four years | 98,038   |
| Due after four years through five years  | 89,102   |
|  | \$ 896,239   |

See "D. Debt" below for cash flow related to outstanding debt.

#### C. Invested Assets

##### Portfolio Composition

An important component of the Company's financial results is the return on its investment portfolio. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well-diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company continues to believe that this strategy enables the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and consistent asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

The following table presents the composition of the total investment portfolio of the Company at December 31, 2016:

|                                    | Cost <sup>(1)</sup>    | Fair Value |
|------------------------------------|------------------------|------------|
|                                    | (Amounts in thousands) |            |
| Fixed maturity securities:         |                        |            |
| U.S. government bonds and agencies | \$ 12,288              | \$ 12,275  |
| Municipal securities               | 2,432,181              | 2,449,292  |
| Mortgage-backed securities         | 39,082                 | 39,777     |
| Corporate securities               | 189,780                | 189,688    |
| Collateralized loan obligations    | 85,429                 | 86,525     |
| Other asset-backed securities      | 36,650                 | 36,996     |
|                                    | 2,795,410              | 2,814,553  |
| Equity securities:                 |                        |            |
| Common stock                       | 286,503                | 316,450    |
| Non-redeemable preferred stock     | 32,436                 | 31,809     |
| Private equity funds               | 12,831                 | 9,068      |
|                                    | 331,770                | 357,327    |

|                        |             |             |
|------------------------|-------------|-------------|
| Short-term investments | 375,700     | 375,680     |
| Total investments      | \$3,502,880 | \$3,547,560 |

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(1) Fixed maturities and short-term bonds at amortized cost and equities and other short-term investments at cost.

At December 31, 2016, 68.8% of the Company's total investment portfolio at fair value and 86.7% of its total fixed maturity investments at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of non-redeemable preferred stocks, dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and private equity funds. At December 31, 2016, 75.9% of short-term investments consisted of highly rated short-duration securities redeemable on a daily or weekly basis. The Company does not have any direct investment in sub-prime lenders.

#### Fixed Maturity Securities and Short-Term Investments

Fixed maturity securities include debt securities, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Short-term investments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

A primary exposure for the fixed maturity securities is interest rate risk. The longer the duration, the more sensitive the asset is to market interest rate fluctuations. As assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy has resulted in a portfolio with a moderate duration. The Company's portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity securities purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The holdings, which are heavily weighted with high coupon issues, are expected to be called prior to maturity. Modified duration measures the length of time it takes, on average, to receive the present value of all the cash flows produced by a bond, including reinvestment of interest. As it measures four factors (maturity, coupon rate, yield and call terms) which determine sensitivity to changes in interest rates, modified duration is considered a better indicator of price volatility than simple maturity alone.

The following table presents the maturity and duration of the Company's fixed maturity securities portfolio:

|  | December 31, 2016 | December 31, 2015 |
|--|-------------------|-------------------|
|  | (in years)        |                   |
| Fixed Maturity Securities                              |                   |                   |
| Nominal average maturities:                            |                   |                   |
| excluding short-term instruments                       | 11.9              | 12.6              |
| including short-term instruments                       | 10.5              | 12.2              |
| Call-adjusted average maturities:                      |                   |                   |
| excluding short-term instruments                       | 4.5               | 3.4               |
| including short-term instruments                       | 4.0               | 3.3               |
| Modified durations reflecting anticipated early calls: |                   |                   |
| excluding short-term instruments                       | 4.1               | 3.2               |
| including short-term instruments                       | 3.7               | 3.1               |
| Collateralized Mortgage Obligations Modified Durations | 3.7               | 1.9               |
| Short-term Instruments                                 | —                 | —                 |

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of A+, at fair value at December 31, 2016, consistent with the average rating at December 31, 2015. The Company's municipal bond holdings of which 99.6% were tax exempt, represented 87.0% of its fixed maturity portfolio at December 31, 2016, at fair value, and are broadly diversified geographically.

To calculate the weighted-average credit quality ratings as disclosed throughout this Annual Report on Form 10-K, individual securities were weighted based on fair value and a credit quality numeric score that was assigned to each security's average of ratings assigned by nationally recognized securities rating organizations.

Taxable holdings consist principally of investment grade issues. At December 31, 2016, fixed maturity holdings rated below investment grade and non-rated bonds totaled \$51.6 million and \$86.6 million, respectively, at fair value, and represented 1.8% and 3.1%, respectively, of total fixed maturity securities. At December 31, 2015, fixed maturity holdings rated below investment



grade and non-rated bonds totaled \$37.5 million and \$6.2 million, respectively, at fair value, and represented 1.3% and 0.2%, respectively, of total fixed maturity securities.

Credit ratings for the Company's fixed maturity portfolio were stable in 2016, with 84.1% of fixed maturity securities at fair value experiencing no change in their overall rating. 10.4% and 5.5% of fixed maturity securities at fair value experienced upgrades and downgrades, respectively, in 2016. The downgrades were slight and still within the investment grade portfolio in 2016.

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The following table presents the credit quality ratings of the Company's fixed maturity portfolio at fair value.

| Security Type                              | December 31, 2016      |                   |                  |                    |                 |              | Total     |   |
|--|------------------------|-------------------|------------------|--------------------|-----------------|--------------|-----------|---|
|  | AAA                    | AA <sup>(1)</sup> | A <sup>(1)</sup> | BBB <sup>(1)</sup> | Non-Rated/Other |              |           |   |
|  | (Dollars in thousands) |                   |                  |                    |                 |              |           |   |
| <b>U.S. government bonds and agencies:</b> |                        |                   |                  |                    |                 |              |           |   |
| Treasuries                                 | \$ 12,275              | \$—               | \$—              | \$—                | \$—             | \$—          | \$ 12,275 |   |
| Government agency                          | —                      | —                 | —                | —                  | —               | —            | —         |   |
| Total                                      | 12,275                 | —                 | —                | —                  | —               | —            | 12,275    |   |
|  | 100.0                  | % —               | —                | —                  | —               | —            | 100.0     | % |
| <b>Municipal securities:</b>               |                        |                   |                  |                    |                 |              |           |   |
| Insured                                    | 64,242                 | 229,807           | 391,361          | 28,007             | 9,275           | 722,692      |           |   |
| Uninsured                                  | 67,725                 | 628,482           | 789,532          | 159,648            | 81,213          | 1,726,600    |           |   |
| Total                                      | 131,967                | 858,289           | 1,180,893        | 187,655            | 90,488          | 2,449,292    |           |   |
|  | 5.4                    | % 35.0            | % 48.2           | % 7.6              | % 3.8           | % 100.0      |           | % |
| <b>Mortgage-backed securities:</b>         |                        |                   |                  |                    |                 |              |           |   |
| Commercial                                 | 4,649                  | 11,828            | 8,191            | 3,883              | 1,427           | 29,978       |           |   |
| Agencies                                   | 3,282                  | —                 | —                | —                  | —               | 3,282        |           |   |
| Non-agencies:                              |                        |                   |                  |                    |                 |              |           |   |
| Prime                                      | —                      | —                 | 529              | 94                 | 1,423           | 2,046        |           |   |
| Alt-A                                      | —                      | —                 | —                | 1,105              | 3,366           | 4,471        |           |   |
| Total                                      | 7,931                  | 11,828            | 8,720            | 5,082              | 6,216           | 39,777       |           |   |
|  | 19.9                   | % 29.7            | % 21.9           | % 12.8             | % 15.6          | % 100.0      |           | % |
| <b>Corporate securities:</b>               |                        |                   |                  |                    |                 |              |           |   |
| Basic materials                            | —                      | —                 | —                | 6,469              | 2,450           | 8,919        |           |   |
| Communications                             | —                      | —                 | 164              | 5,814              | —               | 5,978        |           |   |
| Consumer—cyclical                          | —                      | —                 | 2,231            | 14,211             | 4,559           | 21,001       |           |   |
| Consumer—non-cyclical                      | —                      | —                 | 315              | 4,707              | —               | 5,022        |           |   |
| Energy                                     | —                      | —                 | 6,411            | 23,746             | 31,306          | 61,463       |           |   |
| Financial                                  | —                      | 840               | 23,658           | 32,160             | —               | 56,658       |           |   |
| Industrial                                 | —                      | —                 | 167              | 4,798              | —               | 4,965        |           |   |
| Technology                                 | —                      | —                 | —                | 6,487              | 3,437           | 9,924        |           |   |
| Utilities                                  | —                      | —                 | 6,035            | 9,723              | —               | 15,758       |           |   |
| Total                                      | —                      | 840               | 38,981           | 108,115            | 41,752          | 189,688      |           |   |
|  | —                      | 0.4               | % 20.6           | % 57.0             | % 22.0          | % 100.0      |           | % |
| <b>Collateralized loan obligations:</b>    |                        |                   |                  |                    |                 |              |           |   |
| Corporate                                  | 5,864                  | —                 | 80,661           | —                  | —               | 86,525       |           |   |
| Total                                      | 5,864                  | —                 | 80,661           | —                  | —               | 86,525       |           |   |
|  | 6.8                    | % —               | 93.2             | % —                | —               | 100.0        |           | % |
| <b>Other asset-backed securities</b>       |                        |                   |                  |                    |                 |              |           |   |
|  | 5,197                  | 7,951             | 9,115            | 14,733             | —               | 36,996       |           |   |
|  | 14.0                   | % 21.5            | % 24.6           | % 39.8             | % —             | 100.0        |           | % |
| Total                                      | \$ 163,234             | \$ 878,908        | \$ 1,318,370     | \$ 315,585         | \$ 138,456      | \$ 2,814,553 |           |   |
|  | 5.8                    | % 31.2            | % 46.8           | % 11.2             | % 4.9           | % 100.0      |           | % |

<sup>(1)</sup> Intermediate ratings are included at each level (e.g., AA includes AA+, AA and AA-).

#### U.S. Government Bonds and Agencies

The Company had \$15.6 million, or 0.6% of its fixed maturity portfolio, at fair value, in U.S. government bonds and agencies and mortgage-backed securities (Agencies) at December 31, 2016. In February 2016, Moody's and Fitch affirmed their Aaa and AAA ratings, respectively, for U.S. government issued debt, although a significant increase in government deficits and debt could lead to a downgrade. The Company understands that market participants continue to use rates of return on U.S. government debt as a risk-free rate and have continued to invest in U.S. Treasury securities.

#### Municipal Securities

The Company had \$2.45 billion at fair value (\$2.43 billion at amortized cost) in municipal bonds at December 31, 2016, of which \$722.7 million were insured by bond insurers. The underlying ratings for insured municipal bonds have been factored into the average rating of the securities by the rating agencies with no significant disparity between the absolute bond ratings and the underlying credit ratings as of December 31, 2016.

60.6% of the insured municipal securities, most of which are investment grade, are insured by bond insurers that provide credit enhancement in addition to the ratings reflected by the financial strength of the underlying issuers. At December 31, 2016, the average rating of the Company's insured investment grade municipal securities was A+. The remaining 39.4% of insured municipal securities have bond insurers that have credit ratings below or equal to the financial strength of the underlying issuers; therefore, the Company believes the insurance does not provide a credit enhancement.

The Company considers the strength of the underlying credit as a buffer against potential market value declines which may result from future rating downgrades of the bond insurers. In addition, the Company has a long-term time horizon for its municipal bond holdings, which generally allows it to recover the full principal amounts upon maturity and avoid forced sales prior to maturity of bonds that have declined in market value due to the bond insurers' rating downgrades. Based on the uncertainty surrounding the financial condition of these insurers, it is possible that there will be additional downgrades to below investment grade ratings by the rating agencies in the future, and such downgrades could impact the estimated fair value of those municipal bonds.

#### Mortgage-Backed Securities

At December 31, 2016 and 2015, respectively, the mortgage-backed securities portfolio of \$39.8 million and \$49.8 million at fair value (\$39.1 million and \$49.6 million at amortized cost) was categorized as loans to "prime" borrowers except for \$4.5 million and \$5.4 million (\$4.5 million and \$5.3 million at amortized cost) of Alt-A mortgages. Alt-A mortgage backed securities are at fixed or variable rates and include certain securities that are collateralized by residential mortgage loans issued to borrowers with credit profiles stronger than those of sub-prime borrowers, but do not qualify for prime financing terms due to high loan-to-value ratios or limited supporting documentation. The Company had holdings of \$30.0 million and \$37.3 million (\$29.6 million and \$37.6 million at amortized cost) in commercial mortgage-backed securities at December 31, 2016 and 2015, respectively.

The weighted-average rating of the Company's Alt-A mortgage-backed securities was B- at December 31, 2016, compared to B at December 31, 2015. The weighted-average rating of the entire mortgage backed securities portfolio was A at December 31, 2016, compared to A- at December 31, 2015.

#### Corporate Securities

Included in fixed maturity securities are \$189.7 million and \$243.3 million of corporate securities, which had durations of 2.4 and 2.8 years, at December 31, 2016 and 2015, respectively. The weighted-average rating was BBB- and BBB as of December 31, 2016 and 2015, respectively.

#### Collateralized Loan Obligations

Included in fixed maturities securities are collateralized loan obligations of \$86.5 million and \$50.5 million, which represented 2.4% and 1.5% of the total investment portfolio, and had durations of 4.4 years and 5.7 years at December 31, 2016 and 2015, respectively.

#### Equity Securities

Equity holdings of \$357.3 million consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and private equity funds. The net gains in 2016 due to changes in fair value of the Company's equity portfolio were \$23.7 million. The primary cause of the increase in the value of the Company's equity securities was the overall increase in the equity markets in 2016.

The Company's common stock allocation is intended to enhance the return of and provide diversification for the total portfolio. At December 31, 2016, 10.1% of the total investment portfolio at fair value was held in equity securities, compared to 9.3% at December 31, 2015.

The following table presents the equity security portfolio by industry sector at December 31, 2016 and 2015:

|                       | December 31,<br>2016   |            | 2015      |            |
|-----------------------|------------------------|------------|-----------|------------|
|                       | Cost                   | Fair Value | Cost      | Fair Value |
|                       | (Amounts in thousands) |            |           |            |
| Equity securities:    |                        |            |           |            |
| Basic materials       | \$10,834               | \$12,895   | \$17,094  | \$16,027   |
| Communications        | 15,596                 | 15,935     | 22,226    | 21,759     |
| Consumer—cyclical     | 25,950                 | 28,481     | 34,707    | 38,378     |
| Consumer—non-cyclical | 21,798                 | 22,125     | 31,694    | 32,480     |
| Energy                | 45,230                 | 52,654     | 38,560    | 34,895     |
| Financial             | 56,167                 | 59,226     | 40,730    | 41,974     |
| Funds                 | 37,750                 | 34,840     | 19,017    | 16,676     |
| Industrial            | 26,050                 | 29,665     | 17,261    | 17,110     |
| Technology            | 19,409                 | 22,450     | 19,105    | 18,397     |
| Utilities             | 70,986                 | 79,056     | 73,134    | 77,666     |
|                       | \$331,770              | \$357,327  | \$313,528 | \$315,362  |

#### D. Debt

Notes payable consists of the following:

|                           | Lender                         | Interest Rate              | Expiration                      | December 31, |           |  |
|---------------------------|--------------------------------|----------------------------|---------------------------------|--------------|-----------|--|
|                           |                                |                            |                                 | 2016         | 2015      |  |
|                           | (Amounts in thousands)         |                            |                                 |              |           |  |
| Secured credit facility   | Bank of America                | LIBOR plus 40 basis points | December 3, 2018 <sup>(2)</sup> | \$120,000    | \$120,000 |  |
| Secured loan              | Union Bank                     | LIBOR plus 40 basis points | December 3, 2017                | 20,000       | 20,000    |  |
| Unsecured credit facility | Bank of America and Union Bank | (1)                        | December 3, 2019                | 180,000      | 150,000   |  |
| Total                     |                                |                            |                                 | \$320,000    | \$290,000 |  |

On July 2, 2013, the Company entered into an unsecured \$200 million five-year revolving credit facility, which was later expanded to a borrowing capacity of \$250 million. The interest rate on borrowings under the credit facility is based on the Company's debt to total capital ratio and ranges from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is above 25%. Commitment fees for the

<sup>(1)</sup> undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is above 25%. Debt to capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. In 2016, the interest rate was LIBOR plus 112.5 basis points on the \$180 million of borrowings and 12.5 basis points on the undrawn portion of the credit facility. The interest rate was approximately 1.73% at December 31, 2016.

<sup>(2)</sup> Effective December 28, 2016, the Company extended the maturity date from December 3, 2017 to December 3, 2018.

The bank loan and credit facilities contain financial covenants pertaining to minimum statutory surplus, debt to capital ratio, and RBC ratio. The Company was in compliance with all of its loan covenants at December 31, 2016.

For a further discussion, see Note 7. Notes Payable, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

#### E. Capital Expenditures

In 2016, the Company made capital expenditures, including capitalized software, of approximately \$18.8 million primarily related to Information Technology.

#### F. Regulatory Capital Requirements

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The RBC formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance business having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2016, 2015, and 2014, each of the Insurance Companies exceeded the minimum required RBC level, as determined by the NAIC and adopted by the state insurance regulators. None of the Insurance Companies' RBC ratios were less than 375% of the authorized control level RBC as of December 31, 2016, 2015 and 2014. Generally, an RBC ratio of 200% or less would require some form of regulatory or company action.

Among other considerations, industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.0 to 1. Based on the combined surplus of all the Insurance Companies of \$1.44 billion at December 31, 2016, and net premiums written of \$3.2 billion, the ratio of premiums written to surplus was 2.19 to 1.

Insurance companies are required to file an Own Risk and Solvency Assessment ("ORSA") with the insurance regulators in their domiciliary states. The ORSA is required to cover, among many items, a company's risk management policies, the material risks to which the company is exposed, how the company measures, monitors, manages and mitigates material risks, and how much economic and regulatory capital is needed to continue to operate in a strong and healthy manner. The ORSA is intended to be used by state insurance regulators to evaluate the risk exposure and quality of the risk management processes within insurance companies to assist in conducting risk-focused financial examinations and for determining the overall financial condition of insurance companies. The Company filed its most recent ORSA Summary Report with the California DOI in November 2016. Compliance with the ORSA requirements did not have a material impact on the Company's consolidated financial statements.

The DOI in each state in which the Company operates is responsible for conducting periodic financial and market conduct examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices.

The following table presents a summary of current examinations:

| State | Exam Type               | Period Under Review | Status   |
|-------|-------------------------|---------------------|--|
| GA    | Financial               | 2011 to 2013        | Awaiting final report.                                     |
| CA    | Market Conduct Claims   | 2015                | Fieldwork is expected to begin in the 1st quarter of 2017. |
| CA    | Rating and Underwriting | 2014                | Fieldwork began in July 2014.                              |
| VA    | Market Conduct          | 2014 to 2015        | Received draft report.                                     |

During the course of and at the conclusion of these examinations, the examining DOI generally reports findings to the Company, and none of the findings reported to date are expected to be material to the Company's financial position.

#### OFF-BALANCE SHEET ARRANGEMENTS

As of December 31, 2016, the Company had no off-balance sheet arrangements as defined under Regulation S-K 303(a)(4) and the instructions thereto.





## CONTRACTUAL OBLIGATIONS

The Company's significant contractual obligations at December 31, 2016 are summarized as follows:

| Contractual Obligations <sup>(4)</sup>                   | Total       | Payments Due By Period |           |           |          |          |            |
|--|-------------|------------------------|-----------|-----------|----------|----------|------------|
|  |             | 2017                   | 2018      | 2019      | 2020     | 2021     | Thereafter |
|  |             | (Amounts in thousands) |           |           |          |          |            |
| Debt (including interest) <sup>(1)</sup>                 | \$330,754   | \$23,693               | \$124,028 | \$183,033 | \$—      | \$—      | \$—        |
| Lease obligations <sup>(2)</sup>                         | 27,098      | 14,647                 | 6,784     | 2,713     | 1,945    | 861      | 148        |
| Loss and loss adjustment expense reserves <sup>(3)</sup> | 1,290,248   | 851,692                | 222,556   | 109,147   | 63,773   | 28,858   | 14,222     |
| Total contractual obligations                            | \$1,648,100 | \$890,032              | \$353,368 | \$294,893 | \$65,718 | \$29,719 | \$14,370   |

The Company's debt contains various terms, conditions and covenants which, if violated by the Company, would result in a default and could result in the acceleration of the Company's payment obligations. Amounts differ from

(1) the balances presented on the consolidated balance sheets as of December 31, 2016 because the debt amounts above include interest, calculated by using the average one-month LIBOR rate in 2016 plus the bank margin in effect.

(2) The Company is obligated under various non-cancellable lease agreements providing for office space, automobiles, and office equipment that expire at various dates through the year 2022.

Loss and loss adjustment expense reserves represents an estimate of amounts necessary to settle all outstanding claims, including IBNR as of December 31, 2016. The Company has estimated the timing of these payments based on its historical experience and expectation of future payment patterns. However, the timing of these payments may vary significantly from the amounts shown above. The ultimate cost of losses may vary materially from recorded amounts which are the Company's best estimates. The loss and loss adjustment expense payments in 2016

(3) related to prior years exceeded the payment amount disclosed on this table in our prior year filing by approximately 10%, largely due to increases in prior year loss reserve estimates and normal volatility in payment patterns. The Company believes that cash flows from operations and existing cash and investments are sufficient to meet these obligations despite the uncertainty in payment patterns. For more detailed information on the Company's liquidity and cash flows, see "Liquidity and Capital Resources—B. Cash Flows" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

(4) The table excludes liabilities of \$11.8 million related to uncertainty in tax settlements as the Company is unable to reasonably estimate the timing and amount of related future payments.

#### Item 7A. Quantitative and Qualitative Disclosures about Market Risks

The Company is subject to various market risk exposures primarily due to its investing and borrowing activities. Primary market risk exposures are changes in interest rates, equity prices, and credit risk. Adverse changes to these rates and prices may occur due to changes in the liquidity of a market, or to changes in market perceptions of creditworthiness and risk tolerance. The following disclosure reflects estimates of future performance and economic conditions. Actual results may differ.

##### Overview

The Company's investment policies define the overall framework for managing market and investment risks, including accountability and controls over risk management activities, and specify the investment limits and strategies that are appropriate given the liquidity, surplus, product profile, and regulatory requirements of the Company's subsidiaries. Executive oversight of investment activities is conducted primarily through the Company's investment committee. The Company's investment committee focuses on strategies to enhance after-tax yields, mitigate market risks, and optimize capital to improve profitability and returns.

The Company manages exposures to market risk through the use of asset allocation, duration, and credit ratings. Asset allocation limits place restrictions on the total funds that may be invested within an asset class. Duration limits on the fixed maturities portfolio place restrictions on the amount of interest rate risk that may be taken. Comprehensive day-to-day management of market risk within defined tolerance ranges occurs as portfolio managers buy and sell within their respective markets based upon the acceptable boundaries established by investment policies.

##### Credit Risk

Credit risk results from uncertainty in a counterparty's ability to meet its obligations. Credit risk is managed by maintaining a high credit quality fixed maturities portfolio. As of December 31, 2016, the estimated weighted-average credit quality rating of the fixed maturities portfolio was A+, at fair value, consistent with the average rating at December 31, 2015.

The following table presents municipal bond holdings by state in descending order of holdings at fair value at December 31, 2016:

| States       | Fair Value<br>(Amounts<br>in<br>thousands) | Average Rating |
|--------------|--|----------------|
| Texas        | \$428,534                                  | AA-            |
| California   | 262,313                                    | A+             |
| Florida      | 190,331                                    | A+             |
| Illinois     | 180,623                                    | A              |
| Washington   | 106,535                                    | AA-            |
| Other states | 1,280,956                                  | A+             |
| Total        | \$2,449,292                                |                |

The portfolio is broadly diversified among the states and the largest holdings are in populous states such as Texas and California. These holdings are further diversified primarily among cities, counties, schools, public works, hospitals, and state general obligations. The Company seeks to minimize overall credit risk and ensure diversification by limiting exposure to any particular issuer.

Taxable fixed maturity securities represented 13.3% of the Company's fixed maturity portfolio at December 31, 2016. 4.1% of the Company's taxable fixed maturity securities were comprised of U.S. government bonds and agencies and mortgage-backed securities (Agencies), which were rated AAA at December 31, 2016. 12.8% of the Company's taxable fixed maturity securities, representing 1.7% of its total fixed maturity portfolio, were rated below investment grade. Below investment grade issues are considered "watch list" items by the Company, and their status is evaluated within the context of the Company's overall portfolio and its investment policy on an aggregate risk management basis, as well as their ability to recover their investment on an individual issue basis.

Equity Price Risk

Equity price risk is the risk that the Company will incur losses due to adverse changes in the equity markets.

At December 31, 2016, the Company's primary objective for common equity investments was current income. The fair value of the equity investments consisted of \$316.5 million in common stocks, \$31.8 million in non-redeemable preferred stocks,

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and \$9.1 million in private equity funds. Common stock equity assets are typically valued for future economic prospects as perceived by the market.

Common stocks represented 8.9% of total investments at fair value. Beta is a measure of a security's systematic (non-diversifiable) risk, which is measured as the percentage change in an individual security's return for a 1% change in the return of the market.

Based on hypothetical reductions in the overall value of the stock market, the following table illustrates estimated reductions in the overall value of the Company's common stock portfolio at December 31, 2016 and 2015:

|  | December 31,                                |           |
|--|---|-----------|
|  | 2016  | 2015      |
|  | (Amounts in thousands, except Average Beta) |           |
| Average Beta   | 0.83  | 0.89      |
| Hypothetical reduction in the overall value of the stock market of 25% | \$70,410                                    | \$62,359  |
| Hypothetical reduction in the overall value of the stock market of 50% | \$140,820                                   | \$124,717 |

#### Interest Rate Risk

Interest rate risk is the risk that the Company will incur a loss due to adverse changes in interest rates relative to the interest rate characteristics of interest bearing assets and liabilities. The Company faces interest rate risk, as it invests substantial funds in interest sensitive assets and issues interest sensitive liabilities. Interest rate risk includes risks related to changes in U.S. Treasury yields and other key benchmarks, as well as changes in interest rates resulting from widening credit spreads and credit exposure to collateralized securities.

The value of the fixed maturity portfolio at December 31, 2016, which represented 79.3% of total investments at fair value, is subject to interest rate risk. As market interest rates decrease, the value of the portfolio increases and vice versa. A common measure of the interest sensitivity of fixed maturity assets is modified duration, a calculation that utilizes maturity, coupon rate, yield and call terms to calculate an average age of the expected cash flows generated by such assets. The longer the duration, the more sensitive the asset is to market interest rate fluctuations.

The Company has historically invested in fixed maturity investments with a goal of maximizing after-tax yields and holding assets to the maturity or call date. Since assets with longer maturities tend to produce higher current yields, the Company's historical investment philosophy resulted in a portfolio with a moderate duration. Bond investments made by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The modified duration of the overall bond portfolio reflecting anticipated early calls was 3.7 years at December 31, 2016 compared to 3.2 years and 2.8 years at December 31, 2015 and 2014, respectively.

Given a hypothetical increase of 100 or 200 basis points in interest rates, the Company estimates that the fair value of its bond portfolio at December 31, 2016 would decrease by \$116.4 million or \$232.9 million, respectively.

Conversely, if interest rates were to decrease, the fair value of the Company's bond portfolio would rise, and it may cause a higher number of the Company's bonds to be called away. The proceeds from the called bonds would likely be reinvested at lower yields which would result in lower overall investment income for the Company.

Item 8. Financial Statements and Supplementary Data  
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

Mercury General Corporation:

We have audited the accompanying consolidated balance sheets of Mercury General Corporation and subsidiaries (the Company) as of December 31, 2016 and 2015, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2016. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercury General Corporation and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Mercury General Corporation's internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 9, 2017 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Los Angeles, California

February 9, 2017

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

Mercury General Corporation:

We have audited Mercury General Corporation's internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Mercury General Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Mercury General Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Mercury General Corporation and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2016, and our report dated February 9, 2017 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Los Angeles, California

February 9, 2017

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(in thousands)

|   | December 31, |             |
|---|--------------|-------------|
|   | 2016         | 2015        |
| <b>ASSETS</b>   |              |             |
| Investments, at fair value:   |              |             |
| Fixed maturity securities (amortized cost \$2,795,410; \$2,804,275) | \$2,814,553  | \$2,880,003 |
| Equity securities (cost \$331,770; \$313,528)                       | 357,327      | 315,362     |
| Short-term investments (cost \$375,700; \$185,353)                  | 375,680      | 185,277     |
| Total investments   | 3,547,560    | 3,380,642   |
| Cash  | 220,318      | 264,221     |
| Receivables:  |              |             |
| Premiums  | 459,152      | 436,621     |
| Accrued investment income   | 41,205       | 42,747      |
| Other   | 24,635       | 21,925      |
| Total receivables   | 524,992      | 501,293     |
| Deferred policy acquisition costs                                   | 200,826      | 201,762     |
| Fixed assets, net   | 155,910      | 157,131     |
| Current income taxes  | —            | 9,041       |
| Deferred income taxes   | 45,277       | 23,231      |
| Goodwill  | 42,796       | 42,796      |
| Other intangible assets, net  | 25,625       | 31,702      |
| Other assets  | 25,414       | 16,826      |
| Total assets  | \$4,788,718  | \$4,628,645 |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                         |              |             |
| Loss and loss adjustment expense reserves                           | \$1,290,248  | \$1,146,688 |
| Unearned premiums   | 1,074,437    | 1,049,314   |
| Notes payable   | 320,000      | 290,000     |
| Accounts payable and accrued expenses                               | 112,334      | 122,571     |
| Current income taxes  | 9,962        | —           |
| Other liabilities   | 229,335      | 199,187     |
| Total liabilities   | 3,036,316    | 2,807,760   |
| Commitments and contingencies                                       |              |             |
| Shareholders' equity:   |              |             |
| Common stock without par value or stated value:                     |              |             |
| Authorized 70,000 shares; issued and outstanding 55,289; 55,164     | 95,529       | 90,985      |
| Additional paid-in capital  | —            | 8,870       |
| Retained earnings   | 1,656,873    | 1,721,030   |
| Total shareholders' equity  | 1,752,402    | 1,820,885   |
| Total liabilities and shareholders' equity                          | \$4,788,718  | \$4,628,645 |

See accompanying notes to consolidated financial statements.



MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

|  | Year Ended December 31, |             |             |
|--|-------------------------|-------------|-------------|
|  | 2016                    | 2015        | 2014        |
| Revenues:                              |                         |             |             |
| Net premiums earned                    | \$3,131,773             | \$2,957,897 | \$2,796,195 |
| Net investment income                  | 121,871                 | 126,299     | 125,723     |
| Net realized investment (losses) gains | (34,255 )               | (83,807 )   | 81,184      |
| Other                                  | 8,294                   | 8,911       | 8,671       |
| Total revenues                         | 3,227,683               | 3,009,300   | 3,011,773   |
| Expenses:                              |                         |             |             |
| Losses and loss adjustment expenses    | 2,355,138               | 2,145,495   | 1,986,122   |
| Policy acquisition costs               | 562,545                 | 539,231     | 526,208     |
| Other operating expenses               | 235,314                 | 250,839     | 249,381     |
| Interest                               | 3,962                   | 3,168       | 2,637       |
| Total expenses                         | 3,156,959               | 2,938,733   | 2,764,348   |
| Income before income taxes             | 70,724                  | 70,567      | 247,425     |
| Income tax (benefit) expense           | (2,320 )                | (3,912 )    | 69,476      |
| Net income                             | \$73,044                | \$74,479    | \$177,949   |
| Net income per share:                  |                         |             |             |
| Basic                                  | \$1.32                  | \$1.35      | \$3.23      |
| Diluted                                | \$1.32                  | \$1.35      | \$3.23      |

See accompanying notes to consolidated financial statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands)

|   | Year Ended December 31, |             |             |
|---|-------------------------|-------------|-------------|
|   | 2016                    | 2015        | 2014        |
| Common stock, beginning of year   | \$90,985                | \$88,705    | \$81,591    |
| Proceeds of stock options exercised                                       | 1,818                   | 2,111       | 6,824       |
| Payment for vested restricted stock units and related taxes               | 1,671                   | —           | —           |
| Share-based compensation expense  | 142                     | 142         | 142         |
| Excess tax benefits related to share-based compensation                   | 913                     | 27          | 148         |
| Common stock, end of year   | 95,529                  | 90,985      | 88,705      |
| Additional paid in capital, beginning of year                             | 8,870                   | 3,804       | 411         |
| Share-based compensation expense  | —                       | 5,066       | 3,970       |
| Payment for vested restricted stock units and related taxes               | (5,122 )                | —           | —           |
| Reclassification of restricted stock units from equity to liability award | (3,435 )                | —           | —           |
| Exercise of stock options   | (313 )                  | —           | (577 )      |
| Additional paid in capital, end of year                                   | —                       | 8,870       | 3,804       |
| Retained earnings, beginning of year                                      | 1,721,030               | 1,782,937   | 1,740,484   |
| Net income  | 73,044                  | 74,479      | 177,949     |
| Dividends paid to shareholders  | (137,201 )              | (136,386 )  | (135,496 )  |
| Retained earnings, end of year  | 1,656,873               | 1,721,030   | 1,782,937   |
| Total shareholders' equity  | \$1,752,402             | \$1,820,885 | \$1,875,446 |

See accompanying notes to consolidated financial statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)

|   | Year Ended December 31, |            |            |
|---|-------------------------|------------|------------|
|   | 2016                    | 2015       | 2014       |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                         |            |            |
| Net income  | \$73,044                | \$74,479   | \$177,949  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |            |            |
| Depreciation and amortization   | 26,385                  | 26,478     | 28,054     |
| Net realized investment losses (gains)  | 34,255                  | 83,807     | (81,184 )  |
| Bond amortization, net  | 26,873                  | 21,360     | 18,918     |
| Excess tax benefits related to share-based compensation                           | (913 )                  | (27 )      | (148 )     |
| Increase in premiums receivable   | (22,531 )               | (41,512 )  | (23,934 )  |
| Changes in current and deferred income taxes                                      | (2,130 )                | (35,287 )  | 8,343      |
| Decrease (increase) in deferred policy acquisition costs                          | 936                     | (4,560 )   | (2,736 )   |
| Increase in unpaid losses and loss adjustment expenses                            | 143,560                 | 36,214     | 52,813     |
| Increase in unearned premiums   | 25,124                  | 42,552     | 46,271     |
| (Decrease) increase in accounts payable and accrued expenses                      | (10,586 )               | (35,086 )  | 31,019     |
| Share-based compensation  | 142                     | 5,208      | 4,112      |
| (Decrease) increase in other payables   | (2,627 )                | 18,114     | (10,988 )  |
| Other, net  | (4,059 )                | (1,496 )   | (1,954 )   |
| Net cash provided by operating activities   | 287,473                 | 190,244    | 246,535    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                         |            |            |
| Fixed maturity securities available for sale in nature:                           |                         |            |            |
| Purchases   | (1,077,638 )            | (965,701 ) | (542,494 ) |
| Sales   | 396,766                 | 260,946    | 209,680    |
| Calls or maturities   | 647,059                 | 386,644    | 330,637    |
| Equity securities available for sale in nature:                                   |                         |            |            |
| Purchases   | (714,113 )              | (748,217 ) | (868,383 ) |
| Sales   | 696,138                 | 805,417    | 745,058    |
| Calls   | —                       | 2,851      | 1,044      |
| Changes in securities payable and receivable                                      | 29,958                  | (1,387 )   | 9,294      |
| Net (increase) decrease in short-term investments and purchased options           | (191,530 )              | 187,492    | (56,530 )  |
| Purchase of fixed assets  | (16,979 )               | (20,112 )  | (26,037 )  |
| Sale of fixed assets  | 14                      | 141        | 224        |
| Business acquisition, net of cash acquired  | —                       | 7,771      | —          |
| Other, net  | 3,605                   | 2,473      | 3,472      |
| Net cash used in investing activities   | (226,720 )              | (81,682 )  | (194,035 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                         |            |            |
| Dividends paid to shareholders  | (137,201 )              | (136,386 ) | (135,496 ) |
| Excess tax benefits related to share-based compensation                           | 913                     | 27         | 148        |
| Proceeds from stock options exercised   | 1,632                   | 2,111      | 6,247      |
| Proceeds from bank loan   | 30,000                  | —          | 100,000    |
| Net cash used in financing activities   | (104,656 )              | (134,248 ) | (29,101 )  |
| Net (decrease) increase in cash   | (43,903 )               | (25,686 )  | 23,399     |
| Cash:   |                         |            |            |
| Beginning of year   | 264,221                 | 289,907    | 266,508    |
| End of year   | \$220,318               | \$264,221  | \$289,907  |
| <b>SUPPLEMENTAL CASH FLOW DISCLOSURE</b>  |                         |            |            |
| Interest paid   | \$3,531                 | \$2,989    | \$2,543    |

|                              |        |   |          |          |
|------------------------------|--------|---|----------|----------|
| Income taxes (refunded) paid | \$(183 | ) | \$31,390 | \$61,139 |
|------------------------------|--------|---|----------|----------|

See accompanying notes to consolidated financial statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

General

Mercury General Corporation ("Mercury General") and its subsidiaries (referred to herein collectively as the "Company") are primarily engaged in writing personal automobile insurance through 14 Insurance Companies in 11 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical breakdown, fire, and umbrella insurance. The private passenger automobile line of insurance business was more than 77% of the Company's direct premiums written in 2016, 2015, and 2014, of which approximately 84%, 83%, and 83% of the private passenger automobile premiums were written in California during 2016, 2015, and 2014, respectively. Premiums written represents the premiums charged on policies issued during a fiscal period, which is a statutory measure designed to determine production levels.

Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries:  
 Insurance Companies

|   |  |
|---|--|
| Mercury Casualty Company ("MCC")                        | Mercury National Insurance Company                       |
| Mercury Insurance Company ("MIC")                       | American Mercury Insurance Company                       |
| California Automobile Insurance Company ("CAIC")        | American Mercury Lloyds Insurance Company <sup>(1)</sup> |
| California General Underwriters Insurance Company, Inc. | Mercury County Mutual Insurance Company <sup>(2)</sup>   |
| Mercury Insurance Company of Illinois                   | Mercury Insurance Company of Florida                     |
| Mercury Insurance Company of Georgia                    | Mercury Indemnity Company of America                     |
| Mercury Indemnity Company of Georgia                    | Workmen's Auto Insurance Company ("WAIC") <sup>(4)</sup> |

Non-Insurance Companies

|   |  |
|---|--|
| Mercury Select Management Company, Inc.     | AIS Management LLC                     |
| Mercury Insurance Services LLC              | Auto Insurance Specialists LLC         |
| Animas Funding LLC ("AFL") <sup>(3)</sup>   | PoliSeek AIS Insurance Solutions, Inc. |
| Fannette Funding LLC ("FFL") <sup>(3)</sup> |  |

<sup>(1)</sup> American Mercury Lloyds Insurance Company is not owned but is controlled by the Company through its attorney-in-fact, Mercury Select Management Company, Inc.

<sup>(2)</sup> Mercury County Mutual Insurance Company is not owned but is controlled by the Company through a management contract.

<sup>(3)</sup> Special purpose investment vehicle.

<sup>(4)</sup> California domiciled insurance company acquired in 2015. See Note 20. Acquisition.

The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ("GAAP"), which differ in some respects from those filed in reports to insurance regulatory authorities. All intercompany transactions and balances have been eliminated.

Certain prior period amounts have been reclassified to conform with the current period presentation.

The Company did not have other comprehensive income (loss) in 2016, 2015 and 2014.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about effects of matters that are inherently uncertain and will likely change in subsequent

periods. The most significant assumptions in the preparation of these

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consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates.

#### Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The primary reasons for electing the fair value option were simplification and cost benefit considerations as well as the expansion of the use of fair value measurement by the Company consistent with the long-term measurement objectives of the Financial Accounting Standards Board (the "FASB") for accounting for financial instruments. See Note 2. Fair Value of Financial Instruments for additional information on the fair value option.

Gains and losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment (losses) gains in the Company's consolidated statements of operations, while interest and dividend income on investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company's consolidated statements of operations.

Fixed maturity securities include debt securities, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Premiums and discounts on fixed maturities are amortized using first call date and are adjusted for anticipated prepayments. Premiums and discounts on mortgage-backed securities are adjusted for anticipated prepayment using the retrospective method, with the exception of some beneficial interests in securitized financial assets, which are accounted for using the prospective method.

Equity securities consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and an interest in private equity funds.

Short-term investments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

#### Securities on Deposit

As required by statute, the Company's insurance subsidiaries have securities deposited with the departments of insurance or similar governmental agencies in the states in which they are licensed to operate with fair values totaling \$19 million and \$21 million at December 31, 2016 and 2015, respectively.

#### Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company's deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. Deferred policy acquisition cost amortization was \$562.5 million, \$539.2 million, and \$526.2 million during the years ended December 31, 2016, 2015, and 2014, respectively. The Company does not defer advertising expenditures but expenses them as incurred. The Company recorded net advertising expense of approximately \$40 million, \$44 million, and \$23 million during the years ended December 31, 2016, 2015, and 2014, respectively.

#### Fixed Assets

Fixed assets are stated at historical cost less accumulated depreciation and amortization. The useful life for buildings is 30 to 40 years. Furniture, equipment, and purchased software are depreciated on a combination of straight-line and accelerated methods over 3 to 7 years. The Company has capitalized certain consulting costs, payroll, and payroll-related costs for employees related to computer software developed for internal use, which are amortized on a

straight-line method over the estimated useful life of the software, generally not exceeding 7 years. In accordance with applicable accounting standards, capitalization ceases no later than the point at which a computer software project is substantially complete and ready for its intended use. Leasehold improvements are amortized over the shorter of the useful life of the assets or the life of the associated lease.



The Company periodically assesses long-lived assets or asset groups including building and equipment, for recoverability when events or changes in circumstances indicate that their carrying amounts may not be recoverable. If the Company identifies an indicator of impairment, the Company assesses recoverability by comparing the carrying amount of the asset to the sum of the undiscounted cash flows expected to result from the use and the eventual disposal of the asset. An impairment loss is recognized when the carrying amount is not recoverable and is measured as the excess of carrying value over fair value. There were no impairment charges during 2016, 2015, and 2014.

#### Goodwill and Other Intangible Assets

Goodwill and other intangible assets arise as a result of business acquisitions and consist of the excess of the cost of the acquisitions over the tangible and intangible assets acquired and liabilities assumed and identifiable intangible assets acquired. Identifiable intangible assets consist of the value of customer relationships, trade names, software and technology, and favorable leases, which are all subject to amortization, and an insurance license which is not subject to amortization.

The Company evaluates goodwill and other intangible assets for impairment annually or whenever events or changes in circumstances indicate that it is more likely than not that the carrying amount of goodwill and other intangible assets may exceed their implied fair values. The Company qualitatively determines whether, more likely than not, the fair value exceeds the carrying amount of a reporting unit. There are numerous assumptions and estimates underlying the qualitative assessments including future earnings, long-term strategies, and the Company's annual planning and forecasting process. If these planned initiatives do not accomplish the targeted objectives, the assumptions and estimates underlying the qualitative assessments could be adversely affected and have a material effect upon the Company's financial condition and results of operations. In addition, the Company evaluates other intangible assets using methods similar to those used for goodwill described above. As of December 31, 2016 and 2015, goodwill and other intangible impairment assessments indicated that there was no impairment.

#### Premium Revenue Recognition

Premium revenue is recognized on a pro-rata basis over the terms of the policies in proportion to the amount of insurance protection provided. Premium revenue includes installment and other fees for services which are recognized in the periods in which the services are rendered. Unearned premiums represent the portion of the written premium related to the unexpired policy term. Unearned premiums are predominantly computed monthly on a pro-rata basis and are stated gross of reinsurance deductions, with the reinsurance deduction recorded in other receivables. Net premiums written, a statutory measure designed to determine production levels, were \$3.16 billion, \$3.00 billion, and \$2.84 billion in 2016, 2015, and 2014, respectively.

#### Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses are determined in amounts estimated to cover incurred losses and loss adjustment expenses and established based upon the Company's assessment of claims pending and the development of prior years' loss liabilities. These amounts include liabilities based upon individual case estimates for reported losses and loss adjustment expenses and estimates of such amounts that are incurred but not reported. Changes in the estimated liability are charged or credited to operations as the losses and loss adjustment expenses are re-estimated. The liability is stated net of anticipated salvage and subrogation recoveries. The amount of reinsurance recoverable is included in other receivables.

Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the loss reserve that is required. A key assumption in estimating loss reserves is the degree to which the historical data used to analyze reserves will be predictive of ultimate claim costs on incurred claims. Changes in the regulatory and legal environments, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact this assumption. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims, such as those involving the Company's bodily injury (BI) coverages. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date. However, since the provisions for loss

reserves are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company analyzes loss reserves quarterly primarily using the incurred loss, paid loss, average severity coupled with the claim count development methods, and the generalized linear model ("GLM") described below. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of insurance business or coverage within a line of insurance business. The Company may also evaluate qualitative factors such as known changes in laws or legal ruling that could affect claims handling or other external environmental factors or internal factors that could affect the settlement of claims. When establishing the loss reserve, the Company will generally analyze the results from all of the methods used rather than relying on a single method. While these methods are

designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The incurred loss method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of insurance business which have a long operating history.

The paid loss method analyzes historical payment patterns to estimate the amount of losses yet to be paid.

The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The average severity method coupled with the claim count development method provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing loss reserves. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The GLM determines an average severity for each percentile of claims that have been closed as a percentage of estimated ultimate claims. The average severities are applied to open claims to estimate the amount of losses yet to be paid. The GLM utilizes operational time, determined as a percentile of claims closed rather than a finite calendar period, which neutralizes the effect of changes in the timing of claims handling.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company generally determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on loss reserves established by adjusters and average losses on previous similar catastrophes.

#### Derivative Financial Instruments

The Company accounts for all derivative instruments, other than those that meet the normal purchases and sales exception, as either an asset or liability, measured at fair value, which is based on information obtained from independent parties. In addition, changes in fair value are recognized in earnings unless specific hedge accounting criteria are met. The Company's derivative instruments include total return swaps and options sold. See Note 8.

#### Derivative Financial Instruments.

#### Earnings Per Share

Basic earnings per share excludes dilution and reflects net income divided by the weighted average shares of common stock outstanding during the periods presented. Diluted earnings per share is based on the weighted average shares of common stock and potential dilutive securities outstanding during the periods presented. At December 31, 2016 and 2015, potential dilutive securities consisted of outstanding stock options and restricted stock units ("RSUs") granted from the Company's 2014 Long Term Incentive Plan. See Note 16. Earnings Per Share, for the required disclosures relating to the calculation of basic and diluted earnings per share.

#### Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates or laws is recognized in earnings in the period that includes the enactment date.

At December 31, 2016, the Company's deferred income taxes were in a net asset position, which included a combination of ordinary and capital deferred tax benefits. In assessing the Company's ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that

through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

#### Reinsurance

Liabilities for unearned premiums and unpaid losses are stated in the accompanying consolidated financial statements before deductions for ceded reinsurance. The ceded amounts are immaterial and are carried in other receivables. Earned premiums are stated net of deductions for ceded reinsurance.

The Insurance Companies, as primary insurers, are required to pay losses to the extent reinsurers are unable to discharge their obligations under the reinsurance agreements.

#### Share-Based Compensation

Share-based compensation expense for all stock options granted or modified is based on the estimated grant-date fair value. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is the option vesting term of four or five years for options granted prior to 2008 and four years for options granted subsequent to January 1, 2008, for only those shares expected to vest. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

The fair value of each restricted stock unit grant was determined based on the market price on the grant date for awards classified as equity and on each reporting date for awards classified as a liability. Compensation cost is recognized based on management's best estimate of the performance goals that will be achieved. If such goals are not met, no compensation cost is recognized and any recognized compensation cost would be reversed. See Note 15. Share-Based Compensation for additional disclosures.

#### Recently Issued Accounting Standards

In October 2016, the FASB issued Accounting Standards Update ("ASU") 2016-16, "Income Taxes (Topic 740), Intra-Entity Transfers of Assets Other Than Inventory." ASU 2016-16 requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Current GAAP prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party. ASU 2016-16 will be effective for the Company beginning January 1, 2018. The Company is evaluating the impact that ASU 2016-16 will have on its consolidated financial statements and related disclosures.

In August 2016, the FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments (Topic 230)." The new guidance is intended to reduce diversity in how certain transactions are classified in the consolidated statement of cash flows. ASU 2016-15 will be effective for the Company beginning January 1, 2018. The Company is evaluating the impact that ASU 2016-15 will have on its consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)." The amendments in this ASU replace the "incurred loss" methodology for recognizing credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of information including past events, current conditions and reasonable and supportable forecasts that affect the collectibility of reported amounts of financial assets that are not accounted for at fair value through net income, such as loans, certain debt securities, trade receivables, net investment in leases, off-balance sheet credit exposures and reinsurance receivables. Under the current GAAP incurred loss methodology, recognition of the full amount of credit losses is generally delayed until the loss is probable of incurring. Current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the probability threshold. ASU 2016-13 becomes effective for the Company beginning with the first quarter ending March 31, 2020. The Company is evaluating the impact that ASU 2016-13 will have on its consolidated financial

statements and related disclosures.

In March 2016, the FASB issued ASU 2016-09, "Compensation - Stock Compensation (Topic 718)," which simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for the Company with the quarter ending March 31, 2017. The Company is evaluating the impact that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which supersedes the guidance in Accounting Standards Codification ("ASC") 840, "Leases." ASU 2016-02 requires a lessee to recognize lease assets and lease liabilities

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resulting from all leases. ASU 2016-02 retains the distinction between a finance lease and an operating lease. Lessor accounting is largely unchanged from ASC 840. ASU 2016-02 becomes effective for the Company beginning January 1, 2019. However, in transition, the Company will be required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The Company is evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in this ASU address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01: (1) requires equity investments (except those accounted for under the equity method or those that result in the consolidation of the investee) to be measured at fair value with changes in the fair value recognized in net income; (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (4) requires the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the notes to the financial statements; and (6) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. ASU 2016-01 is effective for the Company beginning January 1, 2018. The Company does not anticipate that ASU 2016-01 will have a material impact on its consolidated financial statements and related disclosures.

In May 2015, the FASB issued ASU 2015-09, "Financial Services -Insurance (Topic 944), Disclosures About Short-Duration Contracts." ASU 2015-09 requires insurance entities to provide additional disclosures related to claims liabilities. The additional disclosure requirements for the annual reports include: (1) claims development information by accident year, on a net of reinsurance basis, for the number of years for which claims incurred remain outstanding but not to exceed the most recent 10 years, and for the most recent reporting period presented, an insurer also needs to disclose the amount of total net outstanding claims for all accident years included in the claims development tables; (2) a reconciliation of claims development information and the aggregate carrying amount of the liability for unpaid claims and claim adjustment expenses; and (3) information about the claims frequency and the amount of the incurred-but-not-reported liabilities for each accident year presented. In addition, a description of the methodology used to determine the amounts disclosed is required. The roll forward of the liability for unpaid claims and claims adjustment expenses, currently required only for annual periods, will also be required for interim periods. ASU 2015-09 became effective for the Company beginning with the annual period ended December 31, 2016, and quarter periods beginning with the first quarter of 2017. Although the adoption of this standard did not have a material impact on its consolidated financial statements, the Company expanded the nature and extent of its insurance contracts disclosures.

In February 2015, the FASB issued ASU 2015-02, "Consolidation (Topic 810), Amendments to the Consolidation Analysis" affecting the consolidation evaluation of limited partnerships and similar entities, fees paid to a decision maker or a service provider as a variable interest, and variable interests in a variable interest entity held by related parties of the reporting entities. The amendments became effective for the Company on January 1, 2016. As in previous GAAP, consolidation analysis under ASU 2015-02 contains two primary consolidation models: the voting control model and the variable interest ("VIE") model. An entity being evaluated for consolidation is required to first be subjected to the requirements of the VIE model. Only if the entity fails to meet the requirements to be consolidated under the VIE model, would the voting control consolidation model apply. The adoption of ASU 2015-02 did not have an impact on the Company's consolidated financial statements and related disclosures.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606)." ASU 2014-09 requires entities to apply a five-step model to determine the amount and timing of revenue recognition. The model

specifies, among other criteria, that revenue should be recognized when an entity transfers control of goods or services to a customer in the amount to which the entity expects to be entitled. In August 2015, the FASB issued ASU 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date," which deferred the effective date of ASU 2014-09 for the Company to January 1, 2018. Through the first half of 2016, the FASB issued additional ASUs on Topic 606 that do not change the core principle of the guidance in ASU 2014-09 but merely clarify certain aspects of it. The additional ASUs also become effective for the Company beginning January 1, 2018. As the accounting for insurance contracts is outside of the scope of ASU 2014-09, the Company does not expect the adoption of this ASU to have a material impact on its financial position, results of operations, or cash flows.

## 2. Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, options sold, total return swaps, accounts payable, and secured and unsecured notes payable. Due to their short-term maturity, the carrying values of



receivables and accounts payable approximate their fair values. All investments are carried at fair value on the consolidated balance sheets.

The following table presents estimated fair values of financial instruments:

|                    | December 31,           |             |
|--------------------|------------------------|-------------|
|                    | 2016                   | 2015        |
|                    | (Amounts in thousands) |             |
| Assets             |                        |             |
| Investments        | \$3,547,560            | \$3,380,642 |
| Total return swaps | 667                    | —           |
| Liabilities        |                        |             |
| Total return swaps | \$765                  | \$11,525    |
| Options sold       | 20                     | 260         |
| Secured notes      | 140,000                | 140,000     |
| Unsecured note     | 180,000                | 150,000     |
| Investments        |                        |             |

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment (losses) gains in the consolidated statements of operations. See Note 3. Investments for additional information.

#### Options Sold

The Company writes covered call options through listed and over-the-counter exchanges. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company on the expiration date as realized gains from investments. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security in determining whether the Company has realized a gain or loss. The Company, as writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option. Liabilities for covered call options of \$0.02 million and \$0.26 million were included in other liabilities at December 31, 2016 and 2015, respectively.

#### Total Return Swaps

The fair values of the total return swaps reflect the estimated amounts that, upon termination of the contracts, would be received for selling an asset or paid to transfer a liability in an orderly transaction at December 31, 2016 and 2015 based on models using inputs, such as interest rate yield curves and credit spreads, observable for substantially the full term of the contract.

#### Secured Notes Payable

The fair value of the Company's \$120 million secured note and \$20 million secured note, classified as Level 2 in the fair value hierarchy described in Note 4. Fair Value Measurement, is estimated based on assumptions and inputs, such as the market value of underlying collateral and reset rates, for similarly termed notes that are observable in the market. The fair values of the secured notes approximated their carrying values.

#### Unsecured Note Payable

The fair value of the Company's \$180 million unsecured note, classified as Level 2 in the fair value hierarchy described in Note 4. Fair Value Measurement, is based on the unadjusted quoted price for similar notes in active markets. The fair value of the unsecured note approximated its carrying value.

For additional disclosures regarding methods and assumptions used in estimating fair values, see Note 4. Fair Value Measurement.



## 3. Investments

The following table presents (losses) gains due to changes in fair value of investments that are measured at fair value pursuant to application of the fair value option:

|                           | Year Ended December 31, |            |           |
|---------------------------|-------------------------|------------|-----------|
|                           | 2016                    | 2015       | 2014      |
|                           | (Amounts in thousands)  |            |           |
| Fixed maturity securities | \$(56,584)              | \$(39,304) | \$77,208  |
| Equity securities         | 23,722                  | (22,988 )  | (32,922 ) |
| Short-term investments    | 57                      | 561        | (527 )    |
| Total                     | \$(32,805)              | \$(61,731) | \$43,759  |

The following table presents gross gains (losses) realized on the sales of investments:

|                           | Year Ended December 31, |            |            |          |          |           |          |           |           |
|---------------------------|-------------------------|------------|------------|----------|----------|-----------|----------|-----------|-----------|
|                           | 2016                    |            |            | 2015     |          |           | 2014     |           |           |
|                           | (Amounts in thousands)  |            |            |          |          |           |          |           |           |
|                           | Gross                   | Gross      | Net        | Gross    | Gross    | Net       | Gross    | Gross     | Net       |
|                           | Realized                | Realized   | Realized   | Realized | Realized | Realized  | Realized | Realized  | Realized  |
|                           | Gains                   | Losses     | Net        | Gains    | Losses   | Net       | Gains    | Losses    | Net       |
| Fixed maturity securities | \$3,327                 | \$(19,133) | \$(15,806) | \$631    | \$(495 ) | \$136     | \$7,015  | \$(9,734) | \$(2,719) |
| Equity securities         | 29,446                  | (29,945 )  | (499 )     | 41,305   | (58,764) | (17,459 ) | 59,342   | (17,705 ) | 41,637    |
| Short-term investments    | 6                       | (529 )     | (523 )     | —        | (1,396 ) | (1,396 )  | —        | (1,943 )  | (1,943 )  |

## Contractual Maturity

At December 31, 2016, fixed maturity holdings rated below investment grade and non-rated comprised 3.9% of total investments at fair value. Additionally, the Company owns securities that are credit enhanced by financial guarantors that are subject to uncertainty related to market perception of the guarantors' ability to perform. Determining the estimated fair value of municipal bonds could become more difficult should markets for these securities become illiquid.

The following table presents the estimated fair values of the Company's fixed maturity securities at December 31, 2016 by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | Estimated Fair Value   |
|--|------------------------|
|  | (Amounts in thousands) |
| Fixed maturity securities:             |                        |
| Due in one year or less                | \$ 381,189             |
| Due after one year through five years  | 515,049                |
| Due after five years through ten years | 316,173                |
| Due after ten years                    | 1,602,142              |
| Total                                  | \$ 2,814,553           |

## Investment Income

The following table presents a summary of net investment income:

|                           | Year Ended December 31, |           |           |
|---------------------------|-------------------------|-----------|-----------|
|                           | 2016                    | 2015      | 2014      |
|                           | (Amounts in thousands)  |           |           |
| Fixed maturity securities | \$104,111               | \$108,122 | \$104,946 |
| Equity securities         | 14,629                  | 14,630    | 17,313    |
| Short-term investments    | 8,936                   | 9,033     | 8,561     |
| Total investment income   | \$127,676               | \$131,785 | \$130,820 |
| Less: investment expense  | (5,805 )                | (5,486 )  | (5,097 )  |
| Net investment income     | \$121,871               | \$126,299 | \$125,723 |

## 4. Fair Value Measurement

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price.

Accordingly, when market observable data are not readily available, the Company's own assumptions are set to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date.

Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based on the level of judgment associated with inputs used to measure their fair value and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Level 2 Pricing inputs are other than quoted prices in active markets, which are based on the following:

Quoted prices for similar assets or liabilities in active markets;

Quoted prices for identical or similar assets or liabilities in non-active markets; or

Either directly or indirectly observable inputs as of the reporting date.

Level 3 Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

## Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on 99.7% of its portfolio from an independent pricing service. For 0.3% of its portfolio, classified as Level 3, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from at least one knowledgeable outside security broker to determine the

fair value as of December 31, 2016. At December 31, 2016 and 2015, \$9.1 million and \$10.4 million, respectively, of equity securities were valued based on broker quotes for underlying debt and credit instruments and an estimated benchmark spread for similar assets in active markets.

**Level 1 Measurements**—Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.

**U.S. government bonds and agencies/Short-term bonds:** Valued using unadjusted quoted market prices for identical assets in active markets.

**Common stock:** Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

**Money market instruments:** Valued based on unadjusted quoted prices for identical assets in active markets.

**Options sold/Purchased options:** Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.

**Level 2 Measurements**—Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

**Municipal securities:** Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.

**Mortgage-backed securities:** Comprised of securities that are collateralized by residential and commercial mortgage loans and valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of \$30.0 million and \$37.3 million at December 31, 2016 and 2015, respectively, in commercial mortgage-backed securities.

**Corporate securities/Short-term bonds:** Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

**Non-redeemable preferred stock:** Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

**Total return swaps:** Valued based on multi-dimensional models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.

**Collateralized loan obligations:** Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets.

**Other asset-backed securities:** Comprised of securities that are collateralized by non-mortgage assets, such as automobile loans, valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets.

**Secured notes payable:** Valued based on underlying collateral and reset rates for similarly termed notes that are observable in the market.

**Unsecured notes payable:** Valued based on the unadjusted quoted price for similar notes in active markets.

**Level 3 Measurements**—Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

**Collateralized debt obligations/Private equity funds:** Valued based on underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, taking into consideration unobservable inputs related to liquidity assumptions.

The Company's financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment (losses) gains in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair values:

|                                    | December 31, 2016      |             |         | Total       |
|------------------------------------|------------------------|-------------|---------|-------------|
|                                    | Level 1                | Level 2     | Level 3 |             |
|                                    | (Amounts in thousands) |             |         |             |
| <b>Assets</b>                      |                        |             |         |             |
| Fixed maturity securities:         |                        |             |         |             |
| U.S. government bonds and agencies | \$12,275               | \$—         | \$—     | \$12,275    |
| Municipal securities               | —                      | 2,449,292   | —       | 2,449,292   |
| Mortgage-backed securities         | —                      | 39,777      | —       | 39,777      |
| Corporate securities               | —                      | 189,688     | —       | 189,688     |
| Collateralized loan obligations    | —                      | 86,525      | —       | 86,525      |
| Other asset-backed securities      | —                      | 36,996      | —       | 36,996      |
| Equity securities:                 |                        |             |         |             |
| Common stock                       | 316,450                | —           | —       | 316,450     |
| Non-redeemable preferred stock     | —                      | 31,809      | —       | 31,809      |
| Private equity funds               | —                      | —           | 9,068   | 9,068       |
| Short-term investments:            |                        |             |         |             |
| Short-term bonds                   | 70,393                 | 20,233      | —       | 90,626      |
| Money market instruments           | 285,054                | —           | —       | 285,054     |
| Other assets:                      |                        |             |         |             |
| Total return swaps                 | —                      | 667         | —       | 667         |
| Total assets at fair value         | \$684,172              | \$2,854,987 | \$9,068 | \$3,548,227 |
| <b>Liabilities</b>                 |                        |             |         |             |
| Notes payable:                     |                        |             |         |             |
| Secured notes                      | \$—                    | \$140,000   | \$—     | \$140,000   |
| Unsecured notes                    | —                      | 180,000     | —       | 180,000     |
| Other liabilities:                 |                        |             |         |             |
| Total return swaps                 | —                      | 765         | —       | 765         |
| Options sold                       | 20                     | —           | —       | 20          |
| Total liabilities at fair value    | \$20                   | \$320,765   | \$—     | \$320,785   |



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| December 31, 2015                      |                  |                    |                 |                    |
|--|------------------|--------------------|-----------------|--------------------|
|  | Level 1          | Level 2            | Level 3         | Total              |
| (Amounts in thousands)                 |                  |                    |                 |                    |
| <b>Assets</b>                          |                  |                    |                 |                    |
| Fixed maturity securities:             |                  |                    |                 |                    |
| U.S. government bonds and agencies     | \$22,507         | \$—                | \$—             | \$22,507           |
| Municipal securities                   | —                | 2,505,040          | —               | 2,505,040          |
| Mortgage-backed securities             | —                | 49,838             | —               | 49,838             |
| Corporate securities                   | —                | 243,372            | —               | 243,372            |
| Collateralized debt obligations        | —                | 50,548             | —               | 50,548             |
| Other asset-backed securities          | —                | 8,698              | —               | 8,698              |
| Equity securities:                     |                  |                    |                 |                    |
| Common stock                           | 280,263          | —                  | —               | 280,263            |
| Non-redeemable preferred stock         | —                | 24,668             | —               | 24,668             |
| Private equity funds                   | —                | —                  | 10,431          | 10,431             |
| Short-term investments:                |                  |                    |                 |                    |
| Short-term bonds                       | 69,991           | 9,850              | —               | 79,841             |
| Money market instruments               | 105,436          | —                  | —               | 105,436            |
| <b>Total assets at fair value</b>      | <b>\$478,197</b> | <b>\$2,892,014</b> | <b>\$10,431</b> | <b>\$3,380,642</b> |
| <b>Liabilities</b>                     |                  |                    |                 |                    |
| Notes payable:                         |                  |                    |                 |                    |
| Secured notes                          | \$—              | \$140,000          | \$—             | \$140,000          |
| Unsecured notes                        | —                | 150,000            | —               | 150,000            |
| Other liabilities:                     |                  |                    |                 |                    |
| Total return swaps                     | —                | 11,525             | —               | 11,525             |
| Options sold                           | 260              | —                  | —               | 260                |
| <b>Total liabilities at fair value</b> | <b>\$260</b>     | <b>\$301,525</b>   | <b>\$—</b>      | <b>\$301,785</b>   |

The following table presents a summary of changes in fair value of Level 3 financial assets:

|   | Private Equity Funds |              |
|---|----------------------|--------------|
|   | Year Ended           |              |
|   | December 31,         | December 31, |
|   | 2016                 | 2015         |
| (Amounts in thousands)  |                      |              |
| Beginning balance   | \$10,431             | \$11,719     |
| Realized losses included in earnings  | (1,363 )             | (4,175 )     |
| Reclassification from other assets  | —                    | 2,911        |
| Sales   | —                    | —            |
| Settlements   | —                    | (24 )        |
| Ending balance  | \$9,068              | \$10,431     |
| The amount of total losses for the period included in earnings attributable to assets still held at December 31 | \$(1,363 )           | \$(5,385 )   |

There were no transfers between Levels 1, 2, and 3 of of the fair value hierarchy in 2016 and 2015.

At December 31, 2016 and 2015, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

5. Fixed Assets

The following table presents the components of fixed assets:

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|  | December 31,           |            |
|--|------------------------|------------|
|  | 2016                   | 2015       |
|  | (Amounts in thousands) |            |
| Land   | \$ 26,770              | \$ 26,770  |
| Buildings and improvements                     | 134,952                | 132,529    |
| Furniture and equipment                        | 114,156                | 109,802    |
| Capitalized software                           | 190,092                | 178,113    |
| Leasehold improvements                         | 9,369                  | 9,109      |
|  | 475,339                | 456,323    |
| Less accumulated depreciation and amortization | (319,429 )             | (299,192 ) |
| Fixed assets, net                              | \$ 155,910             | \$ 157,131 |

Depreciation expense, including amortization of leasehold improvements, was \$20.2 million, \$20.5 million, and \$22.1 million during 2016, 2015, and 2014, respectively.

#### 6. Deferred Policy Acquisition Costs

Deferred policy acquisition costs were as follows:

|                                   | December 31,           |            |            |
|-----------------------------------|------------------------|------------|------------|
|                                   | 2016                   | 2015       | 2014       |
|                                   | (Amounts in thousands) |            |            |
| Balance, beginning of year        | \$ 201,762             | \$ 197,202 | \$ 194,466 |
| Policy acquisition costs deferred | 561,610                | 543,791    | 528,944    |
| Amortization                      | (562,546 )             | (539,231 ) | (526,208 ) |
| Balance, end of year              | \$ 200,826             | \$ 201,762 | \$ 197,202 |

#### 7. Notes Payable

Notes payable consists of the following:

|                           | Lender                         | Interest Rate              | Expiration              | December 31,           |            |
|---------------------------|--------------------------------|----------------------------|-------------------------|------------------------|------------|
|                           |                                |                            |                         | 2016                   | 2015       |
|                           |                                |                            |                         | (Amounts in thousands) |            |
| Secured credit facility   | Bank of America                | LIBOR plus 40 basis points | December 3, 2018<br>(2) | \$ 120,000             | \$ 120,000 |
| Secured loan              | Union Bank                     | LIBOR plus 40 basis points | December 3, 2017        | 20,000                 | 20,000     |
| Unsecured credit facility | Bank of America and Union Bank | (1)                        | December 3, 2019        | 180,000                | 150,000    |
| Total                     |                                |                            |                         | \$ 320,000             | \$ 290,000 |

On July 2, 2013, the Company entered into an unsecured \$200 million five-year revolving credit facility, which later was expanded to a borrowing capacity of \$250 million. The interest rate on borrowings under the credit facility is based on the Company's debt to total capital ratio and ranges from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is above 25%. Commitment fees for the (1) undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is above 25%. Debt to capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. In 2016, the interest rate was LIBOR plus 112.5 basis points on the \$180 million of borrowings and 12.5 basis points on the undrawn portion of the credit facility. The interest rate was approximately 1.73% at December 31, 2016.

(2) Effective December 28, 2016, the Company extended the maturity date from December 3, 2017 to December 3, 2018.

The \$120 million credit facility is secured by municipal bonds held as collateral. The collateral requirement is calculated as the fair market value of the municipal bonds held as collateral multiplied by the advance rates, which vary based on the credit quality and duration of the assets held and range between 75% and 100% of the fair value of each bond.

The \$20 million bank loan has collateral requirements similar to those of the \$120 million credit facility.

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The bank loan and credit facilities contain financial covenants pertaining to minimum statutory surplus, debt to capital ratio, and risk-based capital ("RBC") ratio. The Company was in compliance with all of its loan covenants at December 31, 2016.

The aggregated maturities of notes payable are as follows:

| (Amounts<br>Maturity in<br>thousands) |           |
|---------------------------------------|-----------|
| 2017                                  | \$ 20,000 |
| 2018                                  | 120,000   |
| 2019                                  | 180,000   |

#### 8. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts (options sold) on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities.

The Company also enters into derivative contracts to enhance returns on its investment portfolio.

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle, formed by and consolidated into the Company, entered into a total return swap agreement with Citibank. Under the total return swap agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$30 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest equal to LIBOR plus 145 basis points on approximately \$108 million and \$95 million of underlying obligations as of December 31, 2016 and 2015, respectively. The agreement had an initial term of one year, subject to annual renewal. In January 2017, the agreement was renewed for an additional year expiring February 17, 2018, and the interest rate was changed to LIBOR plus 128 basis points.

On August 9, 2013, Animas Funding LLC ("AFL"), a special purpose investment vehicle, formed and consolidated by the Company, entered into a three-year total return swap agreement with Citibank, which has been renewed for an additional one-year term through February 17, 2018. Under the total return swap agreement, AFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$40 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest equal to LIBOR plus 135 basis points on approximately \$152 million and \$124 million of underlying obligations as of December 31, 2016 and 2015, respectively. The agreement was amended in January 2017 and the interest rate was changed to LIBOR plus 128 basis points.

The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains (losses) in the consolidated statements of operations:

|  | Asset Derivatives      |                   | Liability Derivatives |                   |
|--|------------------------|-------------------|-----------------------|-------------------|
|  | December 31, 2016      | December 31, 2015 | December 31, 2016     | December 31, 2015 |
|  | (Amounts in thousands) |                   |                       |                   |
| Total return swaps - Other assets      | \$667                  | \$ —              | \$ —                  | \$ —              |
| Options sold - Other liabilities       | —                      | —                 | 20                    | 260               |
| Total return swaps - Other liabilities | —                      | —                 | 765                   | 11,525            |

Total derivatives                      \$667 \$                      —\$785 \$ 11,785

|   | Gains (Losses) Recognized<br>in Income |           |           |
|---|--|-----------|-----------|
|   | Year Ended December 31,                |           |           |
|   | 2016                                   | 2015      | 2014      |
|   | (Amounts in thousands)                 |           |           |
| Total return swaps - Net realized investment gains (losses) | \$11,533                               | \$(6,438) | \$(2,969) |
| Options sold - Net realized investment gains                | 3,846                                  | 3,081     | 3,419     |
| Total   | \$15,379                               | \$(3,357) | \$450     |

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Most options sold consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. For additional disclosures regarding equity contracts, see Note 4. Fair Value Measurement.

## 9. Goodwill and Other Intangible Assets

### Goodwill

There were no changes in the carrying amount of goodwill during the periods presented. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the periods presented.

### Other Intangible Assets

The following table presents the components of other intangible assets:

|                              | Gross Carrying Amount<br>(Amounts in thousands) | Accumulated Amortization<br>(Amounts in thousands) | Net Carrying Amount | Useful Lives<br>(in years) |
|------------------------------|---|--|---------------------|----------------------------|
| As of December 31, 2016:     |   |  |                     |                            |
| Customer relationships       | \$52,430  | \$ (39,332 )                                       | \$ 13,098           | 11                         |
| Trade names                  | 15,400  | (5,133 )   | 10,267              | 24                         |
| Technology                   | 4,300   | (3,440 )   | 860                 | 10                         |
| Insurance license            | 1,400   | —  | 1,400               | Indefinite                 |
| Total intangible assets, net | \$73,530  | \$ (47,905 )                                       | \$ 25,625           |                            |
| As of December 31, 2015:     |   |  |                     |                            |
| Customer relationships       | \$52,430  | \$ (34,327 )                                       | \$ 18,103           | 11                         |
| Trade names                  | 15,400  | (4,491 )   | 10,909              | 24                         |
| Technology                   | 4,300   | (3,010 )   | 1,290               | 10                         |
| Insurance license            | 1,400   | —  | 1,400               | Indefinite                 |
| Total intangible assets, net | \$73,530  | \$ (41,828 )                                       | \$ 31,702           |                            |

In 2015, the Company recognized \$1.4 million of other intangible assets for a state insurance license related to the acquisition of Workmen's Auto Insurance Company. See Note 20. Acquisition for the acquisition's cost allocation.

Other intangible assets are reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during any of the periods presented.

Other intangible assets with definite useful lives are amortized on a straight-line basis over their useful lives. Other intangible assets amortization expense was \$6.1 million, \$6.0 million, and \$6.0 million in the years ended December 31, 2016, 2015, and 2014, respectively. None of the intangible assets with definite useful lives are anticipated to have a residual value.

The following table presents the estimated future amortization expense related to other intangible assets as of December 31, 2016:

| Year Ending December 31, Amortization Expense<br>(Amounts in thousands) |          |
|---|----------|
| 2017  | \$ 5,349 |
| 2018  | 5,335    |

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|            |           |
|------------|-----------|
| 2019       | 4,906     |
| 2020       | 758       |
| 2021       | 738       |
| Thereafter | 7,139     |
| Total      | \$ 24,225 |

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## 10. Income Taxes

## Income tax provision

The Company and its subsidiaries file a consolidated federal income tax return. The income tax (benefit) expense consisted of the following components:

|          | Year Ended December 31, |            |          |
|----------|-------------------------|------------|----------|
|          | 2016                    | 2015       | 2014     |
|          | (Amounts in thousands)  |            |          |
| Federal  |                         |            |          |
| Current  | \$17,444                | \$21,942   | \$44,469 |
| Deferred | (21,947 )               | (25,594 )  | 20,444   |
|          | \$(4,503 )              | \$(3,652 ) | \$64,913 |
| State    |                         |            |          |
| Current  | \$2,239                 | \$943      | \$4,421  |
| Deferred | (56 )                   | (1,203 )   | 142      |
|          | \$2,183                 | \$(260 )   | \$4,563  |
| Total    |                         |            |          |
| Current  | \$19,683                | \$22,885   | \$48,890 |
| Deferred | (22,003 )               | (26,797 )  | 20,586   |
| Total    | \$(2,320 )              | \$(3,912 ) | \$69,476 |

The income tax (benefit) expense reflected in the consolidated statements of operations is reconciled to the federal income tax (benefit) expense on income before income taxes based on a statutory rate of 35% as shown in the table below:

|                              | Year Ended December 31, |            |           |
|------------------------------|-------------------------|------------|-----------|
|                              | 2016                    | 2015       | 2014      |
|                              | (Amounts in thousands)  |            |           |
| Computed tax expense at 35%  | \$24,753                | \$24,699   | \$86,598  |
| Tax-exempt interest income   | (26,197 )               | (26,993 )  | (27,839 ) |
| Dividends received deduction | (2,303 )                | (1,613 )   | (2,027 )  |
| State tax expense            | 1,907                   | (287 )     | 3,872     |
| Nondeductible expenses       | 303                     | 575        | 9,900     |
| Other, net                   | (783 )                  | (293 )     | (1,028 )  |
| Income tax (benefit) expense | \$(2,320 )              | \$(3,912 ) | \$69,476  |

## Deferred Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets.



The following table presents the significant components of the Company's net deferred tax assets and liabilities:

|   | December 31,           |           |
|---|------------------------|-----------|
|   | 2016                   | 2015      |
|   | (Amounts in thousands) |           |
| Deferred tax assets:  |                        |           |
| 20% of net unearned premiums  | \$77,104               | \$75,406  |
| Discounting of loss reserves and salvage and subrogation recoverable for tax purposes | 9,864                  | 9,518     |
| Write-down of impaired investments  | 726                    | 857       |
| Tax credit carryforward   | 47,238                 | 36,349    |
| Expense accruals  | 11,090                 | 11,264    |
| Other deferred tax assets   | 8,828                  | 9,596     |
| Total gross deferred tax assets   | 154,850                | 142,990   |
| Deferred tax liabilities:   |                        |           |
| Deferred policy acquisition costs   | (70,289 )              | (70,617 ) |
| Tax liability on net unrealized gain on securities carried at fair value              | (15,612 )              | (23,095 ) |
| Tax depreciation in excess of book depreciation                                       | (10,446 )              | (10,742 ) |
| Undistributed earnings of insurance subsidiaries                                      | (3,985 )               | (4,022 )  |
| Tax amortization in excess of book amortization                                       | (3,030 )               | (2,514 )  |
| Other deferred tax liabilities  | (6,211 )               | (8,769 )  |
| Total gross deferred tax liabilities  | (109,573)              | (119,759) |
| Net deferred tax assets   | \$45,277               | \$23,231  |

The Company had an alternative minimum tax credit carryforward balance of \$47.2 million and \$36.3 million at December 31, 2016 and 2015, respectively, which is not subject to expiration.

#### Uncertainty in Income Taxes

The Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return only if the positions are "more-likely-than-not" sustainable. Once this threshold has been met, the Company's measurement of its expected tax benefits is recognized in its financial statements.

There was a \$0.8 million increase to the total amount of unrecognized tax benefits related to tax uncertainties during 2016. The increase was mainly due to tax positions taken regarding state tax apportionment issues based on management's best judgment given the facts, circumstances and information available at the reporting date. The Company does not expect any changes in such unrecognized tax benefits to have a significant impact on its consolidated financial statements within the next 12 months.

The Company and its subsidiaries file income tax returns with the Internal Revenue Service and the taxing authorities of various states. Tax years that remain subject to examination by major taxing jurisdictions are 2013 through 2015 for federal taxes and 2003 through 2015 for California state taxes. The Company is currently under examination by the California Franchise Tax Board ("FTB") for tax years 2003 through 2013. The FTB issued Notices of Proposed Assessments to the Company for tax years 2003 through 2010, which the Company formally protested. The proposed adjustments for tax years 2003 through 2006 were affirmed following an administrative protest process with the FTB examination. The Company is in settlement discussions with the FTB and believes a reasonable settlement could be reached during 2017 with regards to tax years 2003 through 2010. If a reasonable settlement is not reached, the Company intends to pursue other options, including a formal hearing with the State Board of Equalization or litigation in superior court. Management believes that the resolution of these examinations and assessments will not have a material impact on the consolidated financial statements.



The following table presents a reconciliation of the beginning and ending balances of unrecognized tax benefits:

|  | December 31,           |           |
|--|------------------------|-----------|
|  | 2016                   | 2015      |
|  | (Amounts in thousands) |           |
| Balance at January 1   | \$ 12,165              | \$ 12,612 |
| Additions (reductions) based on tax positions related to:                            |                        |           |
| Current year   | 688                    | 932       |
| Prior years  | 101                    | (1,379 )  |
| Additions (reductions) as a result of lapse of the applicable statute of limitations | —                      | —         |
| Balance at December 31   | \$ 12,954              | \$ 12,165 |

As presented above, the balances of unrecognized tax benefits were \$13.0 million and \$12.2 million at December 31, 2016 and 2015, respectively. Of these totals, \$11.8 million and \$10.9 million at December 31, 2016 and 2015, respectively, represent unrecognized tax benefits, net of federal tax benefit and accrued interest expense which, if recognized, would impact the Company's effective tax rate.

Management does not expect the Company's total amount of unrecognized tax benefits to materially increase within the next twelve months.

The Company recognizes interest and penalties related to unrecognized tax benefits as a part of income taxes. During the years ended December 31, 2016, 2015, and 2014, the Company recognized net interest and penalty expense, excluding refunds, of \$606,000, \$112,000, and \$739,000, respectively. The Company carried an accrued interest and penalty balance of \$3,521,000 and \$2,915,000 at December 31, 2016 and 2015, respectively.

#### 11. Loss and Loss Adjustment Expense Reserves

The following table presents the activity in loss and loss adjustment expense reserves:

|  | Year Ended December 31, |              |              |
|--|-------------------------|--------------|--------------|
|  | 2016                    | 2015         | 2014         |
|  | (Amounts in thousands)  |              |              |
| Gross reserves at January 1                              | \$ 1,146,688            | \$ 1,091,797 | \$ 1,038,984 |
| Less reinsurance recoverable                             | (14,253 )               | (14,192 )    | (13,635 )    |
| Net reserves at January 1                                | 1,132,435               | 1,077,605    | 1,025,349    |
| Acquisition of WAIC reserves                             | —                       | 18,677       | —            |
| Incurred losses and loss adjustment expenses related to: |                         |              |              |
| Current year   | 2,269,769               | 2,132,837    | 1,989,315    |
| Prior years  | 85,369                  | 12,658       | (3,193 )     |
| Total incurred losses and loss adjustment expenses       | 2,355,138               | 2,145,495    | 1,986,122    |
| Loss and loss adjustment expense payments related to:    |                         |              |              |
| Current year   | 1,508,362               | 1,455,245    | 1,347,967    |
| Prior years  | 702,124                 | 654,097      | 585,899      |
| Total payments   | 2,210,486               | 2,109,342    | 1,933,866    |
| Net reserves at December 31                              | 1,277,087               | 1,132,435    | 1,077,605    |
| Reinsurance recoverable                                  | 13,161                  | 14,253       | 14,192       |
| Gross reserves at December 31                            | \$ 1,290,248            | \$ 1,146,688 | \$ 1,091,797 |

The increase in the provision for insured events of prior years in 2016 of approximately \$85.4 million primarily resulted from the California and Florida automobile lines of business which experienced higher loss severity on liability coverages including Bodily Injury, Combined Single Limits and Property Damage than was originally estimated.

The increase in the provision for insured events of prior years in 2015 of approximately \$12.7 million primarily resulted from the California homeowners and automobile lines of business outside of California, which was partially offset by favorable development in the California automobile line of business.

The decrease in the provision for insured events of prior years in 2014 of approximately \$3.2 million primarily resulted from lower than expected loss severity on California personal automobile lines of insurance business partially offset by adverse development in other states.

The Company experienced pre-tax catastrophe losses and loss adjustment expenses from severe weather events of \$27 million, \$19 million, and \$11 million in 2016, 2015, and 2014, respectively. The losses in 2016 were primarily due to severe storms outside of California, and rainstorms in California. The losses in 2015 were primarily due to severe storms outside of California, and rainstorms and wildfires in California. The losses in 2014 were primarily related to winter freeze events on the East Coast and severe rainstorms in California.

The following is information about incurred and paid claims development as of December 31, 2016, net of reinsurance, as well as cumulative claim frequency and the total of incurred-but-not-reported liabilities plus expected development on reported claims included within the net incurred claims amounts for our two major product lines: automobile and homeowners lines of business. The cumulative number of reported claims represents open claims, claims closed with payment, and claims closed without payment. It does not include an estimated amount for unreported claims. The number of claims is measured by claim event (such as a car accident or storm damage) and an individual claim event may result in more than one reported claim. The Company considers a claim that does not result in a liability as a claim closed without payment.

The information about incurred and paid claims development for the years ended December 31, 2007 to 2015 is presented as unaudited supplementary information.

Incurred Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Automobile Insurance)

For the Years Ended December 31,

| Accident<br>Year       | 2007 <sup>(1)</sup> | 2008 <sup>(1)</sup> | 2009 <sup>(1)</sup> | 2010 <sup>(1)</sup> | 2011 <sup>(1)</sup> | 2012 <sup>(1)</sup> | 2013 <sup>(1)</sup> | 2014 <sup>(1)</sup> | 2015 <sup>(1)</sup> | 2016 <sup>(1)</sup> |
|------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| (Amounts in thousands) |                     |                     |                     |                     |                     |                     |                     |                     |                     |                     |
| 2007                   | \$1,591,217         | \$1,610,874         | \$1,614,648         | \$1,624,875         | \$1,633,606         | \$1,633,169         | \$1,634,127         | \$1,635,529         | \$1,636,379         | \$1,637,230         |
| 2008                   |                     | 1,505,732           | 1,440,301           | 1,442,691           | 1,455,858           | 1,461,084           | 1,463,659           | 1,465,623           | 1,466,108           | 1,467,000           |
| 2009                   |                     |                     | 1,372,833           | 1,349,025           | 1,361,116           | 1,361,652           | 1,365,551           | 1,371,779           | 1,372,694           | 1,373,500           |
| 2010                   |                     |                     |                     | 1,367,547           | 1,357,750           | 1,364,307           | 1,374,638           | 1,379,336           | 1,381,056           | 1,382,000           |
| 2011                   |                     |                     |                     |                     | 1,343,919           | 1,367,000           | 1,380,557           | 1,388,363           | 1,393,878           | 1,395,000           |
| 2012                   |                     |                     |                     |                     |                     | 1,424,754           | 1,408,222           | 1,409,104           | 1,414,878           | 1,420,000           |
| 2013                   |                     |                     |                     |                     |                     |                     | 1,448,567           | 1,431,058           | 1,447,881           | 1,450,000           |
| 2014                   |                     |                     |                     |                     |                     |                     |                     | 1,467,175           | 1,454,366           | 1,470,000           |
| 2015                   |                     |                     |                     |                     |                     |                     |                     |                     | 1,551,105           | 1,580,000           |
| 2016                   |                     |                     |                     |                     |                     |                     |                     |                     |                     | 1,670,000           |

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<sup>(1)</sup> The information for the years 2007 to 2015 is presented as unaudited supplemental information.



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Cumulative Paid Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Automobile Insurance)  
For the Years Ended December 31,

| Accident Year          | 2007 <sup>(1)</sup> | 2008 <sup>(1)</sup> | 2009 <sup>(1)</sup> | 2010 <sup>(1)</sup> | 2011 <sup>(1)</sup> | 2012 <sup>(1)</sup> | 2013 <sup>(1)</sup> | 2014 <sup>(1)</sup> | 2015 <sup>(1)</sup> | 2016  |
|------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---|
| (Amounts in thousands) |                     |                     |                     |                     |                     |                     |                     |                     |                     |   |
| 2007                   | \$1,040,933         | \$1,365,854         | \$1,496,543         | \$1,581,001         | \$1,615,964         | \$1,628,413         | \$1,633,178         | \$1,634,888         | \$1,635,631         | \$1,636,384   |
| 2008                   |                     | 992,844             | 1,226,787           | 1,345,354           | 1,418,274           | 1,450,172           | 1,459,216           | 1,463,384           | 1,464,763           | 1,465,152   |
| 2009                   |                     |                     | 913,340             | 1,137,807           | 1,260,424           | 1,326,439           | 1,355,210           | 1,363,526           | 1,370,564           | 1,371,953   |
| 2010                   |                     |                     |                     | 908,954             | 1,143,984           | 1,268,142           | 1,335,871           | 1,365,464           | 1,375,799           | 1,377,188   |
| 2011                   |                     |                     |                     |                     | 926,983             | 1,152,459           | 1,277,808           | 1,347,082           | 1,378,920           | 1,380,309   |
| 2012                   |                     |                     |                     |                     |                     | 955,647             | 1,194,648           | 1,304,511           | 1,372,828           | 1,374,217   |
| 2013                   |                     |                     |                     |                     |                     |                     | 974,445             | 1,217,906           | 1,340,724           | 1,342,113   |
| 2014                   |                     |                     |                     |                     |                     |                     |                     | 967,481             | 1,231,413           | 1,232,802   |
| 2015                   |                     |                     |                     |                     |                     |                     |                     |                     | 1,040,253           | 1,041,642   |
| 2016                   |                     |                     |                     |                     |                     |                     |                     |                     |                     | 1,091,031   |
|                        |                     |                     |                     |                     |                     |                     |                     |                     | Total               | \$13,380,253  |
|                        |                     |                     |                     |                     |                     |                     |                     |                     |                     | All outstanding liabilities before 2007, net of reinsurance             |
|                        |                     |                     |                     |                     |                     |                     |                     |                     |                     | Loss and allocated loss adjustment expense reserves, net of reinsurance |

<sup>(1)</sup> The information for the years 2007 to 2015 is presented as unaudited supplemental information.

Incurred Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Homeowners' Insurance)

For the Years Ended December 31,

| Accident Year          | 2007 <sup>(1)</sup> | 2008 <sup>(1)</sup> | 2009 <sup>(1)</sup> | 2010 <sup>(1)</sup> | 2011 <sup>(1)</sup> | 2012 <sup>(1)</sup> | 2013 <sup>(1)</sup> | 2014 <sup>(1)</sup> | 2015 <sup>(1)</sup> | 2016        | As of December 31, 2016 |
|------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|-------------|-------------------------|
| (Amounts in thousands) |                     |                     |                     |                     |                     |                     |                     |                     |                     |             |                         |
| 2007                   | \$119,505           | \$116,950           | \$112,042           | \$111,378           | \$109,836           | \$110,052           | \$110,092           | \$110,161           | \$110,142           | \$110,204   | \$42,144                |
| 2008                   |                     | 146,486             | 139,549             | 138,605             | 139,142             | 138,190             | 138,803             | 139,149             | 139,156             | 139,216     | 5,166                   |
| 2009                   |                     |                     | 135,889             | 135,000             | 131,680             | 133,087             | 133,121             | 134,718             | 134,597             | 134,478     | (3,177)                 |
| 2010                   |                     |                     |                     | 165,727             | 157,566             | 160,983             | 160,472             | 160,206             | 160,015             | 159,608     | (17,211)                |
| 2011                   |                     |                     |                     |                     | 167,414             | 170,623             | 170,052             | 169,600             | 169,390             | 169,621     | 325,233                 |
| 2012                   |                     |                     |                     |                     |                     | 196,063             | 188,010             | 190,376             | 191,548             | 192,057     | 585,253                 |
| 2013                   |                     |                     |                     |                     |                     |                     | 191,903             | 188,915             | 188,026             | 186,795     | 775,233                 |
| 2014                   |                     |                     |                     |                     |                     |                     |                     | 199,298             | 202,621             | 203,218     | 2,993,253               |
| 2015                   |                     |                     |                     |                     |                     |                     |                     |                     | 234,800             | 234,881     | 9,431,243               |
| 2016                   |                     |                     |                     |                     |                     |                     |                     |                     |                     | 250,440     | 36,538,233              |
|                        |                     |                     |                     |                     |                     |                     |                     |                     | Total               | \$1,780,518 |                         |

<sup>(1)</sup> The information for the years 2007 to 2015 is presented as unaudited supplemental information.

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Cumulative Paid Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Homeowners' Insurance)  
For the Years Ended December 31,

| Accident Year | 2007 <sup>(1)</sup>    | 2008 <sup>(1)</sup> | 2009 <sup>(1)</sup> | 2010 <sup>(1)</sup> | 2011 <sup>(1)</sup> | 2012 <sup>(1)</sup> | 2013 <sup>(1)</sup> | 2014 <sup>(1)</sup> | 2015 <sup>(1)</sup>   | 2016        |
|---------------|------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---|-------------|
|               | (Amounts in thousands) |                     |                     |                     |                     |                     |                     |                     |   |             |
| 2007          | \$71,165               | \$100,774           | \$104,340           | \$108,404           | \$109,305           | \$109,874           | \$109,932           | \$109,949           | \$110,064   | \$110,075   |
| 2008          |                        | 86,954              | 122,239             | 129,821             | 135,500             | 137,284             | 138,137             | 138,680             | 138,809   | 138,922     |
| 2009          |                        |                     | 86,034              | 119,306             | 126,591             | 130,928             | 132,180             | 134,381             | 134,378   | 134,301     |
| 2010          |                        |                     |                     | 95,057              | 137,628             | 149,084             | 155,191             | 156,853             | 158,053   | 158,943     |
| 2011          |                        |                     |                     |                     | 111,909             | 153,845             | 162,870             | 166,375             | 167,806   | 168,621     |
| 2012          |                        |                     |                     |                     |                     | 128,618             | 175,029             | 182,756             | 188,121   | 190,373     |
| 2013          |                        |                     |                     |                     |                     |                     | 133,528             | 174,295             | 180,858   | 183,860     |
| 2014          |                        |                     |                     |                     |                     |                     |                     | 139,615             | 186,996   | 194,605     |
| 2015          |                        |                     |                     |                     |                     |                     |                     |                     | 163,196   | 213,994     |
| 2016          |                        |                     |                     |                     |                     |                     |                     |                     |   | 173,435     |
|               |                        |                     |                     |                     |                     |                     |                     |                     | Total   | \$1,667,129 |
|               |                        |                     |                     |                     |                     |                     |                     |                     | All outstanding liabilities before 2007, net of reinsurance             | 2,661       |
|               |                        |                     |                     |                     |                     |                     |                     |                     | Loss and allocated loss adjustment expense reserves, net of reinsurance | \$116,050   |

<sup>(1)</sup> The information for the years 2007 to 2015 is presented as unaudited supplemental information.

The following is unaudited supplementary information about average historical claims duration as of December 31, 2016.

Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance

| Years                | 1     | 2     | 3    | 4    | 5    | 6    | 7    | 8    | 9    | 10 |
|----------------------|-------|-------|------|------|------|------|------|------|------|----|
| Automobile insurance | 66.0% | 17.1% | 8.5% | 4.9% | 2.2% | 0.7% | 0.4% | 0.1% | 0.1% | —  |

Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance

| Years                | 1     | 2     | 3    | 4    | 5    | 6    | 7    | 8 | 9    | 10 |
|----------------------|-------|-------|------|------|------|------|------|---|------|----|
| Homeowners insurance | 66.1% | 24.3% | 4.6% | 3.0% | 1.0% | 0.7% | 0.2% | — | 0.1% | —  |

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The reconciliation of the net incurred and paid claims development tables to the liability for claims and claim adjustment expenses in the consolidated balance sheets is as follows.

Reconciliation of the Disclosure of Incurred and Paid Claims Development to the Loss and Loss Adjustment Expense Reserves

|   | December<br>31, 2016<br>(Amounts<br>in<br>thousands) |
|---|--|
| Net outstanding liabilities                                   |  |
| Automobile insurance  | \$1,016,832  |
| Homeowners' insurance   | 116,050  |
| WAIC automobile insurance                                     | 12,232   |
| Other short-duration insurance lines                          | 51,320   |
| Loss and loss adjustment expense reserves, net of reinsurance | 1,196,434  |
| Reinsurance recoverable on unpaid claims                      |  |
| Automobile insurance  | 12,601   |
| Homeowners' insurance   | 199  |
| Other short-duration insurance lines                          | 360  |
| Total reinsurance recoverable on unpaid claims                | 13,160   |
| Insurance lines other than short-duration                     | 1,480  |
| Unallocated claims adjustment expenses                        | 79,174   |
|   | 80,654   |
| Total gross loss and loss adjustment expense reserves         | \$1,290,248  |

## 12. Dividends

The following table presents shareholder dividends paid:

|                | Year Ended December 31,                       |            |            |
|----------------|---|------------|------------|
|                | 2016  | 2015       | 2014       |
|                | (Amounts in thousands, except per share data) |            |            |
| Total paid     | \$ 137,201                                    | \$ 136,386 | \$ 135,496 |
| Per share paid | \$ 2.4825                                     | \$ 2.4725  | \$ 2.4625  |

The Insurance Companies are subject to the financial capacity guidelines established by their domiciliary states. The payment of dividends from statutory unassigned surplus of the Insurance Companies is restricted, subject to certain statutory limitations. As of December 31, 2016, the insurance subsidiaries of the Company are permitted to pay approximately \$144 million in dividends in 2017 to Mercury General without the prior approval of the DOI of domiciliary states. The above statutory regulations may have the effect of indirectly limiting the ability of the Company to pay shareholder dividends. During 2016, 2015, and 2014, the Insurance Companies paid Mercury General ordinary dividends of \$111 million, \$133 million, and \$225 million, respectively.

On February 3, 2017, the Board of Directors declared a \$0.6225 quarterly dividend payable on March 30, 2017 to shareholders of record on March 16, 2017.

## 13. Statutory Balances and Accounting Practices

The Insurance Companies prepare their statutory-basis financial statements in conformity with accounting practices prescribed or permitted by the insurance departments of their domiciliary states. Prescribed statutory accounting practices primarily include those published as statements of statutory accounting principles by the National Association of Insurance Commissioners (the "NAIC"), as well as state laws, regulations, and general administrative

rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed. As of December 31, 2016, there were no material permitted statutory accounting practices utilized by the Insurance Companies.

The following table presents the statutory net income, and statutory capital and surplus of the Insurance Companies, as reported to regulatory authorities:

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|                                     | Year Ended December 31, |             |             |
|-------------------------------------|-------------------------|-------------|-------------|
|                                     | 2016                    | 2015        | 2014        |
|                                     | (Amounts in thousands)  |             |             |
| Statutory net income <sup>(1)</sup> | \$82,359                | \$123,984   | \$155,654   |
| Statutory capital and surplus       | \$1,441,571             | \$1,451,950 | \$1,438,281 |

(1) Statutory net income reflects differences from GAAP net income, including changes in the fair value of the investment portfolio as a result of the application of the fair value option.

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The RBC formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance business having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2016, 2015, and 2014, each of the Insurance Companies exceeded the minimum required RBC level, as determined by the NAIC and adopted by the state insurance regulators. None of the Insurance Companies' RBC ratios were less than 375% of the authorized control level RBC as of December 31, 2016, 2015 and 2014. Generally, an RBC ratio of 200% or less would require some form of regulatory or company action.

#### 14. Profit Sharing Plan and Annual Cash Bonuses

The Company's employees are eligible to become members of the Profit Sharing Plan (the "Plan"). The Company, at the option of the Board of Directors, may make annual contributions to the Plan, and the contributions are not to exceed the greater of the Company's net income for the plan year or its retained earnings at that date. In addition, the annual contributions may not exceed an amount equal to 15% of the compensation paid or accrued during the year to all participants under the Plan. No contributions were made in the past three years.

The Plan includes an option for employees to make salary deferrals under Section 401(k) of the Internal Revenue Code. The matching contributions, at a rate set by the Board of Directors, totaled \$8.2 million, \$8.5 million, and \$8.0 million for 2016, 2015, and 2014, respectively.

The Plan also includes an employee stock ownership plan that covers substantially all employees. The Board of Directors authorizes the Plan to purchase the Company's common stock in the open market for allocation to the Plan participants. No purchases were made during the past three years.

The Company also provides annual cash bonuses to eligible employees based on performance criteria for each recipient and for the Company as a whole. The Company performance goals were based on the Company's premium growth and combined ratio. The Company paid annual cash bonuses of \$16.8 million, \$20.7 million, and \$19.1 million in 2016, 2015, and 2014, respectively.

#### 15. Share-Based Compensation

In February 2015, the Company adopted the 2015 Incentive Award Plan (the "2015 Plan"), replacing the 2005 Equity Incentive Plan (the "2005 Plan") which expired in January 2015. The 2015 Plan was approved at the Company's Annual Meeting of Shareholders in May 2015. A maximum of 4,900,000 shares of common stock under the 2015 Plan are authorized for issuance upon exercise of stock options, stock appreciation rights and other awards, or upon vesting of restricted or deferred stock awards. As of December 31, 2016, only stock options and restricted stock unit awards have been granted under these plans.

|  | Year Ended December    |         |         |
|--|------------------------|---------|---------|
|  | 31,                    |         |         |
|  | 2016                   | 2015    | 2014    |
|  | (Amounts in thousands) |         |         |
| Cash received from stock option exercises  | \$1,505                | \$2,111 | \$6,247 |
| Compensation cost, all share-based awards  | 142                    | 5,208   | 4,112   |
| Excess tax benefit, all share-based awards | 913                    | 27      | 148     |



Stock Option Awards

Beginning January 1, 2008, stock options granted, for which the Company has recognized share-based compensation expense, become exercisable at a rate of 25% per year beginning one year from the date granted, are granted at the closing price of the Company's stock on the date of grant, and expire after 10 years. Prior to January 1, 2008, stock options granted became exercisable at a rate of 20% per year.

No stock options were awarded in 2016, 2015, and 2014 under the 2015 Plan or 2005 Plan. The fair values of stock options awarded in 2013 under the 2005 Plan were estimated on the dates of grant using a closed-form option valuation model (Black-Scholes). The following table provides the assumptions used in the calculation of grant-date fair values of stock options awarded during 2013 based on the Black-Scholes option pricing model:

|  |                 |
|--|-----------------|
|  | 2013            |
| Weighted-average grant-date fair value | \$7.11          |
| Expected volatility                    | 33.16% - 33.18% |
| Weighted-average expected volatility   | 33.17%          |
| Risk-free interest rate                | 0.88% - 1.60%   |
| Expected dividend yield                | 5.40% - 5.76%   |
| Expected term in months                | 72              |

Expected volatilities are based on historical volatility of the Company's stock over the term of the stock options. The Company estimated the expected term of stock options, which represents the period of time that stock options granted are expected to be outstanding, by using historical exercise patterns and post-vesting termination behavior. The risk free interest rate is determined based on U.S. Treasury yields with equivalent remaining terms in effect at the time of the grant.

The following table presents a summary of the stock option activity under the Company's plans for the year ended December 31, 2016:

|                                  | Shares   | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value (in 000's) |
|----------------------------------|----------|---------------------------------|---|--------------------------------------|
| Outstanding at January 1, 2016   | 168,000  | \$ 48.14                        |   |                                      |
| Granted                          | —        | —                               |   |                                      |
| Exercised                        | (62,500) | \$ 46.12                        |   |                                      |
| Canceled or expired              | (20,000) | \$ 57.10                        |   |                                      |
| Outstanding at December 31, 2016 | 85,500   | \$ 47.52                        | 3.1   | \$ 1,085                             |
| Exercisable at December 31, 2016 | 65,500   | \$ 48.73                        | 2.1   | \$ 752                               |

The aggregate intrinsic values in the table above represent the total pre-tax intrinsic value (the difference between the Company's closing stock price and the stock option exercise price, multiplied by the number of in-the-money stock options) that would have been received by the stock option holders had all stock options been exercised on December 31, 2016. The aggregate intrinsic values of stock options exercised were \$591,000, \$303,000, and \$1,160,000 during 2016, 2015, and 2014, respectively. The total fair value of stock options vested during each of 2016, 2015, and 2014 was \$142,000.

The following table presents information regarding stock options outstanding at December 31, 2016:

| Range of Exercise Prices | Options Outstanding |   |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
|                          | Number of Options   | Weighted-Average Remaining Contractual Life (Years) | Weighted-Average Exercise Price | Number of Options   | Weighted-Average Exercise Price |
| \$33.61-\$45.30          | 41,000              | 5.7   | \$ 42.44                        | 21,000              | \$ 41.40                        |

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|                 |        |     |          |        |          |
|-----------------|--------|-----|----------|--------|----------|
| \$47.61-\$50.35 | 15,000 | 1.3 | \$ 48.52 | 15,000 | \$ 48.52 |
| \$51.51-\$54.93 | 29,500 | 0.4 | \$ 54.06 | 29,500 | \$ 54.06 |

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As of December 31, 2016, \$60,000 of total unrecognized compensation cost related to non-vested stock options is expected to be recognized over a weighted-average remaining contractual life of 0.5.

#### Restricted Stock Unit Awards

Under the 2015 Plan and 2005 Plan, the Compensation Committee of the Company's Board of Directors granted performance-based vesting restricted stock unit awards to the Company's senior management and key employees.

The following table presents the restricted stock unit grants summary at December 31, 2016:

|   | Grant Year |         |         |
|---|------------|---------|---------|
|   | 2016       | 2015    | 2014    |
| Three-year performance period ending December 31, | 2018       | 2017    | 2016    |
| Vesting shares, target (net of forfeited)         | 93,250     | 95,750  | 82,000  |
| Vesting shares, maximum (net of forfeited)        | 174,844    | 179,531 | 153,750 |

The following table presents a summary of restricted stock unit awards activity during the years indicated:

|                            | Year Ended December 31, |                                       | 2015    |                                       | 2014     |                                       |
|----------------------------|-------------------------|---------------------------------------|---------|---------------------------------------|----------|---------------------------------------|
|                            | 2016                    | Weighted-Average Fair Value per Share | Shares  | Weighted-Average Fair Value per Share | Shares   | Weighted-Average Fair Value per Share |
| Outstanding at January 1   | 263,250                 | \$ 45.94                              | 167,000 | \$ 41.15                              | 170,500  | \$ 39.64                              |
| Granted                    | 95,750                  | \$ 53.49                              | 100,250 | \$ 53.80                              | 93,500   | \$ 45.17                              |
| Vested                     | (78,500)                | \$ 36.82                              | —       | —                                     | —        | —                                     |
| Forfeited/Canceled         | (9,500)                 | \$ 50.46                              | (4,000) | \$ 43.10                              | (16,500) | \$ 43.99                              |
| Expired                    | —                       | —                                     | —       | —                                     | (80,500) | \$ 44.01                              |
| Outstanding at December 31 | 271,000                 | \$ 51.09                              | 263,250 | \$ 45.94                              | 167,000  | \$ 41.15                              |

The restricted stock units vest at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company's performance during the performance period achieves the threshold established by the Compensation Committee of the Company's Board of Directors. For 2014, 2015 and 2016 grants, vesting is based on the Company's cumulative underwriting income, annual underwriting income, and net earned premium growth. As of December 31, 2016, 2,500, 3,500, and 3,500 target restricted stock units granted in 2016, 2015 and 2014, respectively, have been forfeited because the recipients were no longer employed by the Company. Expired shares represent shares that did not meet the vesting requirements.

The fair value of each restricted stock unit grant was determined based on the closing price of the Company's common stock on the grant date for awards classified as equity and on each reporting date for awards classified as a liability. Compensation cost is recognized based on management's best estimate that performance goals will be achieved. If such goals are not met, no compensation cost will be recognized and any recognized compensation cost would be reversed.

In February 2016, 88,074 shares of common stock, net of 58,822 shares withheld for payroll taxes, were issued upon the vesting of 146,896 RSUs awarded in 2013 resulting from the attainment of performance goals above the target threshold during the three-year performance period from 2013 to 2015.

At December 31, 2016, the Company determined that it is probable that the Company's Board of Directors will modify the payment method for the vested 2014 grant awards and pay for the vested awards in cash in lieu of shares of the Company's common stock. As a result, the 2014 grants were reclassified from equity to liability awards at December 31, 2016. \$3.4 million of the amount previously recognized in additional paid-in capital for the 2014 grant

awards was reclassified to other liabilities in the consolidated balance sheets at December 31, 2016.

## 16. Earnings Per Share

The following table presents a reconciliation of the numerators and denominators of the basic and diluted earnings per share calculations:

|   | Year Ended December 31, |                                     |                     | 2015                  |                                     |                     | 2014                  |                                     |                     |
|---|-------------------------|-------------------------------------|---------------------|-----------------------|-------------------------------------|---------------------|-----------------------|-------------------------------------|---------------------|
|   | 2016                    | Weighted<br>Shares<br>(Denominator) | Per-Share<br>Amount | Income<br>(Numerator) | Weighted<br>Shares<br>(Denominator) | Per-Share<br>Amount | Income<br>(Numerator) | Weighted<br>Shares<br>(Denominator) | Per-Share<br>Amount |
| (Amounts and numbers in thousands, except per-share data)         |                         |                                     |                     |                       |                                     |                     |                       |                                     |                     |
| <b>Basic EPS</b>  |                         |                                     |                     |                       |                                     |                     |                       |                                     |                     |
| Income available to common stockholders                           | \$73,044                | 55,249                              | \$ 1.32             | \$74,479              | 55,157                              | \$ 1.35             | \$177,949             | 55,008                              | \$ 3.23             |
| Effect of dilutive securities:                                    |                         |                                     |                     |                       |                                     |                     |                       |                                     |                     |
| Options   | —                       | 11                                  | —                   | —                     | 15                                  | —                   | —                     | 12                                  | —                   |
| RSUs  | —                       | 42                                  | —                   | —                     | 37                                  | —                   | —                     | —                                   | —                   |
| <b>Diluted EPS</b>  |                         |                                     |                     |                       |                                     |                     |                       |                                     |                     |
| Income available to common stockholders after assumed conversions | \$73,044                | 55,302                              | \$ 1.32             | \$74,479              | 55,209                              | \$ 1.35             | \$177,949             | 55,020                              | \$ 3.23             |

Potentially dilutive securities representing approximately 27,600, 67,000, and 252,000 shares of common stock for 2016, 2015, and 2014, respectively, were excluded from the computation of diluted earnings per common share because their effect would have been anti-dilutive.

## 17. Commitments and Contingencies

## Operating Leases

The Company is obligated under various non-cancellable lease agreements providing for office space, automobiles, and office equipment that expire at various dates through the year 2022. For leases that contain predetermined escalations of the minimum rentals, the Company recognizes the related rent expense on a straight-line basis and records the difference between the recognized rental expense and amounts payable under the leases as deferred rent in other liabilities. This liability amounted to \$2.4 million and \$3.6 million at December 31, 2016 and 2015, respectively. Total rent expense under these lease agreements was \$19.7 million, \$16.0 million, and \$14.6 million for 2016, 2015, and 2014, respectively.

The following table presents future minimum commitments for operating leases as of December 31, 2016:

| Year Ending December 31, | Operating Leases |
|--------------------------|------------------|
| (Amounts in thousands)   |                  |
| 2017                     | \$ 14,647        |
| 2018                     | 6,784            |
| 2019                     | 2,713            |
| 2020                     | 1,945            |
| 2021                     | 861              |
| Thereafter               | 148              |

## California Earthquake Authority ("CEA")

The CEA is a quasi-governmental organization that was established to provide a market for earthquake coverage to California homeowners. The Company places all new and renewal earthquake coverage offered with its homeowners policies directly with the CEA. The Company receives a small fee for placing business with the CEA, which is recorded as other income in the consolidated statements of operations. Upon the occurrence of a major seismic event, the CEA has the ability to assess participating companies for losses. These assessments are made after CEA capital has been expended and are based upon each company's participation percentage multiplied by the amount of the total

assessment. Based upon the most recent information provided by the CEA, the

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Company's maximum total exposure to CEA assessments at April 1, 2016, the most recent date at which information was available, was approximately \$60.2 million. There was no assessment made in 2016.

#### Regulatory Matters

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, "2004 NNC") alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer's insurance broker. The California DOI sought to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker fee, to impose a penalty for each policy on which the Company allegedly used a misleading advertisement, and to suspend certificates of authority for a period of one year. In January 2012, the administrative law judge bifurcated the 2004 NNC between (a) the California DOI's order to show cause (the "OSC"), in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance (the "NNC"), in which the California DOI asserts the unlawful rate allegations. In February 2012, the administrative law judge ("ALJ") submitted a proposed decision dismissing the NNC, but the Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior Court in April 2012, and the Commissioner responded with a demurrer. Following a hearing, the Superior Court sustained the Commissioner's demurrer, based on the Company's failure to exhaust its administrative remedies, and the Company appealed. The Court of Appeal affirmed the Superior Court's ruling that the Company was required to exhaust its administrative remedies, but expressly preserved for later appeal the legal basis for the ALJ's dismissal: violation of the Company's due process rights. Following an evidentiary hearing in April 2013, post-hearing briefs, and an unsuccessful mediation, the ALJ closed the evidentiary record on April 30, 2014. Although a proposed decision was to be submitted to the Commissioner on or before June 30, 2014, after which the Commissioner would have 100 days to accept, reject or modify the proposed decision, the proposed decision was not submitted until December 8, 2014. On January 7, 2015, the Commissioner adopted the ALJ's proposed decision, which became the Commissioner's adopted order (the "Order"). The decision and Order found that from the period July 1, 1996, through 2006, the Company's "brokers" were actually operating as "de facto agents" and that the charging of "broker fees" by these producers constituted the charging of "premium" in excess of the Company's approved rates, and assessed a civil penalty in the amount of \$27.6 million against the Company. On February 9, 2015, the Company filed a Writ of Administrative Mandamus and Complaint for Declaratory Relief (the "Writ") in the Orange County Superior Court seeking, among other things, to require the Commissioner to vacate the Order, to stay the Order while the Superior Court action is pending, and to judicially declare as invalid the Commissioner's interpretation of certain provisions of the California Insurance Code. Subsequent to the filing of the Writ, a consumer group petitioned and was granted the right to intervene in the Superior Court action. The Court did not order a stay, and the \$27.6 million assessed penalty was paid in March 2015. The Company filed an amended Writ on September 11, 2015, adding an explicit request for a refund of the penalty, with interest.

On August 12, 2016, the Superior Court issued its ruling on the Writ, for the most part granting the relief sought by the Company. The Superior Court found that the Commissioner and the California DOI did commit due process violations, but declined to dismiss the case on those grounds. The Superior Court also agreed with the Company that the broker fees at issue were not premium, and that the penalties imposed by the Commissioner were improper, and therefore vacated the Order imposing the penalty. The Superior Court entered final judgment on November 17, 2016, issuing a writ requiring the Commissioner to refund the entire penalty amount within 120 days, plus prejudgment interest at the statutory rate of 7%. The Company has filed a motion with the ALJ to dismiss the false advertising OSC portion of the NNC based on the Superior Court's findings and legal reasoning. On January 12, 2017, the Commissioner filed a notice of appeal of the Superior Court's judgment entered on November 17, 2016. Since the matter has been appealed, the Company has not yet recognized in the consolidated financial statements the vacation of the Commissioner's Order or established a receivable for the refund of the \$27.6 million penalty plus any related interest owed.

The Company has also accrued a liability for the estimated cost to continue to defend itself in the false advertising OSC. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the false advertising OSC will be material to its financial position.

#### Litigation

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see Note 1. Summary of Significant Accounting Policies.

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be



reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate.

The Company is also involved in proceedings relating to assessments and rulings made by the FTB. See Note 10. Income Taxes.

There are no environmental proceedings arising under federal, state, or local laws or regulations to be discussed.

#### 18. Risks and Uncertainties

Many businesses are experiencing the effects of uncertain conditions in the global economy and capital markets, reduced consumer spending and confidence, and continued volatility, which could adversely impact the Company's financial condition, results of operations, and liquidity. Further, volatility in global capital markets could adversely affect the Company's investment portfolio. The Company is unable to predict the impact of current and future global economic conditions on the United States, and California, where the majority of the Company's business is produced.

The Company applies the fair value option to its investment portfolio. Rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within the Company's financial statements, and the period-to-period changes in value could vary significantly. Decreases in market value may have a material adverse effect on the Company's financial condition or results of operations.

#### 19. Quarterly Financial Information (Unaudited)

The following table presents summarized quarterly financial data for 2016 and 2015:

|   | Quarter Ended                                 |           |              |             |
|---|---|-----------|--------------|-------------|
|   | March 31                                      | June 30   | September 30 | December 31 |
|   | (Amounts in thousands, except per share data) |           |              |             |
| 2016  |   |           |              |             |
| Net premiums earned   | \$767,085                                     | \$779,321 | \$790,850    | \$794,517   |
| Change in fair value of investments pursuant to the fair value option | 18,531  | 37,127    | (21,132)     | (67,332)    |
| Income before income taxes  | 26,034  | 64,335    | 31,625       | (51,270)    |
| Net income (loss)   | 23,323  | 48,873    | 26,930       | (26,082)    |
| Basic earnings per share <sup>(1)</sup>                               | 0.42  | 0.88      | 0.49         | (0.47)      |
| Diluted earnings per share <sup>(1)</sup>                             | 0.42  | 0.88      | 0.49         | (0.47)      |
| Dividends paid per share  | 0.6200  | 0.6200    | 0.6200       | 0.6225      |
| 2015  |   |           |              |             |
| Net premiums earned   | \$720,737                                     | \$731,546 | \$745,520    | \$760,094   |
| Change in fair value of investments pursuant to the fair value option | (4,884)                                       | (40,783)  | (18,538)     | 2,474       |
| Income before income taxes  | 29,859  | 4,511     | 12,267       | 23,930      |
| Net income  | 26,165  | 9,639     | 15,270       | 23,405      |
| Basic earnings per share <sup>(1)</sup>                               | 0.47  | 0.17      | 0.28         | 0.42        |

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|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Diluted earnings per share <sup>(1)</sup> | 0.47   | 0.17   | 0.28   | 0.42   |
| Dividends paid per share                  | 0.6175 | 0.6175 | 0.6175 | 0.6200 |

<sup>(1)</sup> The basic and diluted earnings per share do not sum due to rounding.

Net income during 2016 was primarily affected by an increase in losses and loss adjustment expenses partially offset by an increase in net premiums earned, unfavorable development on prior accident years' loss and loss adjustment expense reserves, severe storms outside of California and rainstorms in California, and net realized investment losses. The primary cause of the net loss for the fourth quarter of 2016 was the declines in the fair value of the Company's fixed maturity securities due to the rising market interest rates.

Net income for 2015 was primarily affected by net realized investment losses, and an increase in losses and loss adjustment expenses partially offset by an increase in net premiums earned. Net income for the fourth quarter of 2015 was affected by net realized investment losses of \$8.2 million.

## 20. Acquisition

Pursuant to an October 22, 2014 Stock Purchase Agreement, the Company purchased all the issued and outstanding shares of Workmen's Auto Insurance Company ("WAIC"), a California domiciled property and casualty insurance company, on January 2, 2015.

WAIC is a Los Angeles-based non-standard, private passenger automobile insurance company that operates predominantly in California. The Company intends to use the WAIC non-standard automobile product to complement the Company's preferred and standard product offerings.

The Company paid \$8 million in cash for the shares of WAIC, of which \$2 million has been held in escrow for up to three years as security for any loss development on claims incurred on or prior to June 30, 2014. Based on the evaluation performed at the acquisition date and at December 31, 2015, of the claims reserves for WAIC for losses and loss adjustment expenses incurred on or prior to June 30, 2014, the Company estimated that it would recover the \$2 million held in escrow and, therefore, the Company deducted it from cash consideration to arrive at the fair value of total consideration transferred. The Company recovered the \$2 million held in escrow in 2016. In accordance with regulatory approval requirements, the Company made a \$15 million cash capital contribution to WAIC on January 12, 2015.

## 21. Segment Information

The Company is primarily engaged in writing personal automobile insurance and provides related property and casualty insurance products to its customers through 14 subsidiaries in 11 states, principally in California.

The Company has one reportable business segment - the Property and Casualty business segment.

The Company's Chief Operating Decision Maker evaluates operating results based on pre-tax underwriting results which is calculated as net premiums earned less (a) losses and loss adjustment expenses; and (b) underwriting expenses (policy acquisition costs and other operating expenses).

Expenses are allocated based on certain assumptions that are primarily related to premiums and losses. The Company's net investment income, net realized investment gains (losses), other income, and interest expense are excluded in evaluating pre-tax underwriting profit. The Company does not allocate its assets, including investments, or income taxes in evaluating pre-tax underwriting profit.

### Property and Casualty Lines

The Property and Casualty business segment offers several insurance products to the Company's individual customers and small business customers. These insurance products are: private passenger automobile, which is the Company's primary business, and related insurance products such as homeowners, commercial automobile and commercial property. These insurance products are primarily sold to the Company's individual customers and small business customers, which increases retention of the Company's private personal automobile client base. The insurance products comprising the Property and Casualty business segment are sold through the same distribution channels, mainly through independent and 100% owned insurance agents, and go through a similar underwriting process.

### Other Lines

The Other business segment represents net premiums written and earned from an operating segment that does not meet the quantitative thresholds required to be considered a reportable segment. This operating segment offers automobile mechanical breakdown warranties which are primarily sold through automobile dealerships and credit

unions.

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The following table presents operating results by reportable segment for the years ended:

|  | December 31, 2016                  |        |           | December 31, 2015                  |        |           | December 31, 2014                  |        |           |
|--|------------------------------------|--------|-----------|------------------------------------|--------|-----------|------------------------------------|--------|-----------|
|  | Property<br>&<br>Casualty<br>Lines | Other  | Total     | Property<br>&<br>Casualty<br>Lines | Other  | Total     | Property<br>&<br>Casualty<br>Lines | Other  | Total     |
| (Amounts in millions)                  |                                    |        |           |                                    |        |           |                                    |        |           |
| Net premiums earned                    | \$3,089.9                          | \$41.9 | \$3,131.8 | \$2,906.6                          | \$51.3 | \$2,957.9 | \$2,737.3                          | \$58.9 | \$2,796.2 |
| Less:                                  |                                    |        |           |                                    |        |           |                                    |        |           |
| Losses and loss adjustment expenses    | 2,333.2                            | 21.9   | 2,355.1   | 2,117.3                            | 28.2   | 2,145.5   | 1,951.4                            | 34.7   | 1,986.1   |
| Underwriting expenses                  | 780.4                              | 17.5   | 797.9     | 770.0                              | 20.0   | 790.0     | 749.7                              | 25.9   | 775.6     |
| Underwriting (loss) gain               | (23.7 )                            | 2.5    | (21.2 )   | 19.3                               | 3.1    | 22.4      | 36.2                               | (1.7 ) | 34.5      |
| Investment income                      |                                    |        | 121.9     |                                    |        | 126.3     |                                    |        | 125.7     |
| Net realized investment (losses) gains |                                    |        | (34.3 )   |                                    |        | (83.8 )   |                                    |        | 81.2      |
| Other income                           |                                    |        | 8.3       |                                    |        | 8.9       |                                    |        | 8.7       |
| Interest expense                       |                                    |        | (4.0 )    |                                    |        | (3.2 )    |                                    |        | (2.6 )    |
| Pre-tax income                         |                                    |        | \$70.7    |                                    |        | \$70.6    |                                    |        | \$247.4   |
| Net income                             |                                    |        | \$73.0    |                                    |        | \$74.5    |                                    |        | \$177.9   |

The following table presents the Company's net premiums earned and direct premiums written by line of insurance business for the years ended:

|                              | December 31, 2016                  |        |           | December 31, 2015                  |        |           | December 31, 2014                  |        |           |
|------------------------------|------------------------------------|--------|-----------|------------------------------------|--------|-----------|------------------------------------|--------|-----------|
|                              | Property<br>&<br>Casualty<br>Lines | Other  | Total     | Property<br>&<br>Casualty<br>Lines | Other  | Total     | Property<br>&<br>Casualty<br>Lines | Other  | Total     |
| (Amounts in millions)        |                                    |        |           |                                    |        |           |                                    |        |           |
| Private passenger automobile | \$2,435.7                          | \$—    | \$2,435.7 | \$2,308.6                          | \$—    | \$2,308.6 | \$2,203.0                          | \$—    | \$2,203.0 |
| Homeowners                   | 414.0                              | —      | 414.0     | 379.7                              | —      | 379.7     | 347.9                              | —      | 347.9     |
| Commercial automobile        | 161.3                              | —      | 161.3     | 144.4                              | —      | 144.4     | 121.8                              | —      | 121.8     |
| Other                        | 78.9                               | 41.9   | 120.8     | 73.9                               | 51.3   | 125.2     | 64.6                               | 58.9   | 123.5     |
| Net premiums earned          | \$3,089.9                          | \$41.9 | \$3,131.8 | \$2,906.6                          | \$51.3 | \$2,957.9 | \$2,737.3                          | \$58.9 | \$2,796.2 |
| Private passenger automobile | \$2,452.7                          | \$—    | \$2,452.7 | \$2,345.8                          | \$—    | \$2,345.8 | \$2,223.1                          | \$—    | \$2,223.1 |
| Homeowners                   | 436.9                              | —      | 436.9     | 402.2                              | —      | 402.2     | 374.5                              | —      | 374.5     |
| Commercial automobile        | 166.1                              | —      | 166.1     | 153.5                              | —      | 153.5     | 135.9                              | —      | 135.9     |
| Other                        | 89.0                               | 27.3   | 116.3     | 81.6                               | 29.8   | 111.4     | 75.4                               | 44.3   | 119.7     |
| Direct premiums written      | \$3,144.7                          | \$27.3 | \$3,172.0 | \$2,983.1                          | \$29.8 | \$3,012.9 | \$2,808.9                          | \$44.3 | \$2,853.2 |

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company's management,

including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure

controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

#### Management's Report on Internal Control Over Financial Reporting

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2016. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework (2013). Based upon its assessment, the Company's management believes that, as of December 31, 2016, the Company's internal control over financial reporting is effective based on these criteria.

KPMG LLP, the independent registered public accounting firm that audited the consolidated financial statements included in this 2016 Annual Report on Form 10-K, has issued an audit report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2016, which is included herein.

#### Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company's process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.

#### Item 9B. Other Information

None

PART III

Item 10. Directors, Executive Officers, and Corporate Governance

Item 11. Executive Compensation

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 13. Certain Relationships and Related Transactions, and Director Independence

Item 14. Principal Accounting Fees and Services

Information regarding executive officers of the Company is included in Part I. For other information called for by Items 10, 11, 12, 13 and 14, reference is made to the Company's definitive proxy statement for its Annual Meeting of Shareholders, which will be filed with the SEC within 120 days after December 31, 2016 and which is incorporated herein by reference.



## PART IV

## Item 15. Exhibits and Financial Statement Schedules

The following documents are filed as a part of this report:

1. Financial Statements: The Consolidated Financial Statements for the year ended December 31, 2016 are contained herein as listed in the Index to Consolidated Financial Statements on page 53.

2. Financial Statement Schedules:

Report of Independent Registered Public Accounting Firm

Schedule I—Summary of Investments—Other than Investments in Related Parties

Schedule II—Condensed Financial Information of Registrant

Schedule IV—Reinsurance

All other schedules are omitted as the required information is inapplicable or the information is presented in the Consolidated Financial Statements or Notes thereto.

## 3. Exhibits

| Form 10-K Exhibit No. | Description of Exhibit  | If Incorporated by Reference, Documents with Which Exhibit was Previously Filed with the SEC   |
|-----------------------|---|--|
| 3.1                   | Articles of Incorporation of the Company, as amended to date.   | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1997, and is incorporated herein by this reference.                           |
| 3.2                   | Amended and Restated Bylaws of the Company.   | This document was filed as an exhibit to Registrant's Form 10-Q for the quarterly period ended September 30, 2007, and is incorporated herein by this reference.                     |
| 3.3                   | First Amendment to Amended and Restated Bylaws of the Company.  | This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 4, 2008, and is incorporated herein by this reference.    |
| 3.4                   | Second Amendment to Amended and Restated Bylaws of the Company.   | This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on February 25, 2009, and is incorporated herein by this reference. |
| 4.1                   | Shareholders' Agreement dated as of October 7, 1985 among the Company, George Joseph and Gloria Joseph. | This document was filed as an exhibit to Registrant's Registration Statement on Form S-1, File No. 33-899, and is incorporated herein by this reference.                             |
| 4.2                   | Form of Indenture between Mercury General Corporation and Wilmington Trust, National Association.       | This document was filed as an exhibit to Registrant's Registration Statement on Form S-3, File No. 333-215344, and is incorporated herein by this reference.                         |
| 10.1*                 | Profit Sharing Plan, as Amended and Restated as of March 11, 1994.                                      | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1993, and is incorporated herein by this reference.                           |
| 10.2*                 | Amendment 1994-I to the Mercury General Corporation Profit Sharing Plan.                                | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1994, and is incorporated herein by this reference.                           |
| 10.3*                 | Amendment 1994-II to the Mercury General Corporation Profit Sharing Plan.                               | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1994, and is incorporated herein by this reference.                           |
| 10.4*                 | Amendment 1996-I to the Mercury General Corporation Profit Sharing Plan.                                | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1996, and is incorporated herein by this reference.                           |
| 10.5*                 |   |  |

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Amendment 1997-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1996, and is incorporated herein by this reference.

- 10.6\* Amendment 1998-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1997, and is incorporated herein by this reference.
- 10.7\* Amendment 1999-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1999, and is incorporated herein by this reference.
- 10.8\* Amendment 1999-II to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1999, and is incorporated herein by this reference.
- 10.9\* Amendment 2001-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2001, and is incorporated herein by this reference.
- 10.10\* Amendment 2002-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2002, and is incorporated herein by this reference.
- 10.11\* Amendment 2002-2 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2002, and is incorporated herein by this reference.
- 10.12\* Amendment 2003-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2004, and is incorporated herein by this reference.
- 10.13\* Amendment 2004-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2004, and is incorporated herein by this reference.
- 10.14\* Amendment 2006-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2007, and is incorporated herein by this reference.
- 10.15\* Amendment 2006-2 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2006, and is incorporated herein by this reference.
- 10.16\* Amendment 2007-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2007, and is incorporated herein by this reference.
- 10.17\* Amendment 2008-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2008, and is incorporated herein by this reference.
- 10.18\* Amendment 2008-2 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2008, and is incorporated herein by this reference.
- 10.19\* Amendment 2009-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2009, and is incorporated herein by this reference.
- 10.20\* Amendment 2009-2 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2009, and is incorporated herein by this reference.
- 10.21\* Amendment 2011-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2011, and is incorporated herein by this reference.
- 10.22\* Amendment 2013-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2013, and is incorporated herein by this reference.

|   |  |
|---|--|
| Plan.   | reference.   |
| 10.23* Amendment 2014-1 to the Mercury General Corporation Profit Sharing Plan. | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2014, and is incorporated herein by this reference. |
| 10.24* Amendment 2014-2 to the Mercury General Corporation Profit Sharing Plan. | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2014, and is incorporated herein by this reference. |
| 10.25* Amendment 2015-1 to the Mercury General Corporation Profit Sharing Plan. | This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2015, and is incorporated herein by this reference. |

10.26\* Amendment 2015-2 to the Mercury General Corporation Profit Sharing Plan.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2015, and is incorporated herein by this reference.

10.27 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Casualty Company, Mercury Insurance Company, California Automobile Insurance Company and California General Insurance Company.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.28 Expense Reimbursement and Services Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and American Mercury Insurance Company.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.29 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Georgia.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.30 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Georgia.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.31 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Illinois.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.32 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Illinois.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.33 Management Agreement effective January 1, 2002 between Mercury Insurance Services, LLC and Mercury Insurance Company of Florida and Mercury Indemnity Company of Florida.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2001, and is incorporated herein by this reference.

10.34 Management Agreement dated January 22, 1997 between Mercury County Mutual Insurance Company and Mercury Insurance Services, LLC.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2006, and is incorporated herein by this reference.

10.35\* Director Compensation Arrangements.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2013, and is incorporated herein by this reference.

10.36\* Mercury General Corporation Senior Executive Incentive Bonus Plan.

This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 10, 2013, and is incorporated herein by this reference.

10.37\* Amended and Restated Mercury General Corporation 2005 Equity Incentive Award Plan.

This document was filed as an exhibit to the Registrant's Form 8-K filed with the Securities and Exchange Commission on November 1, 2010, and is incorporated herein by this reference.

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10.38\* Form of Incentive Stock Option Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan.

10.39\* Form of Restricted Stock Unit Award Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan.

10.40 Credit Agreement, dated as of January 2, 2009, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto.

10.41 Amendment Agreement to Credit Agreement, dated as of January 26, 2009, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto.

This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 16, 2005, and is incorporated herein by this reference.

This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on October 5, 2010, and is incorporated herein by this reference.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2008, and is incorporated herein by this reference.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2008, and is incorporated herein by this reference.

- 10.42 Second Amendment Agreement to Credit Agreement, dated as of August 4, 2011, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 5, 2011, and is incorporated herein by this reference.
- 10.43 Third Amendment Agreement to Credit Agreement, dated as of July 31, 2013, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 5, 2013, and is incorporated herein by this reference.
- 10.44 Fourth Amendment Agreement to Credit Agreement, dated as of December 3, 2014, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on December 8, 2014, and is incorporated herein by this reference.
- 10.45 Fifth Amendment Agreement to Credit Agreement, dated as of December 28, 2016, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on December 29, 2016, and is incorporated herein by this reference.
- 10.46\* Mercury General Corporation Annual Incentive Plan. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 2, 2011, and is incorporated herein by this reference.
- 10.47 Credit Agreement, dated as of July 2, 2013, by and among Mercury General Corporation, Bank of America, as Administrative Agent, and the Lenders party thereto. This document was filed as an exhibit to Registrant's Form 10-Q for the quarterly period ended June 30, 2013, and is incorporated herein by this reference.
- 10.48 First Amendment Agreement to Credit Agreement, dated as of December 3, 2014, among Mercury General Corporation, Bank of America, N.A., and the lenders party thereto. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on December 8, 2014, and is incorporated herein by this reference.
- 10.49\* Mercury General Corporation 2015 Incentive Award Plan. This document was filed as an exhibit to Registrant's Form S-8 filed with the Securities and Exchange Commission on February 20, 2015 (File No. 333-202204), and is incorporated herein by this reference.
- 10.50\* Form of Restricted Stock Unit Agreement under the Mercury General Corporation 2015 Incentive Award Plan. This document was filed as an exhibit to Registrant's Form S-8 filed with the Securities and Exchange Commission on February 20, 2015 (File No. 333-202204), and is incorporated herein by this reference.
- 10.51\* Form of Stock Option Agreement under the Mercury General Corporation 2015 Incentive Award Plan. This document was filed as an exhibit to Registrant's Form S-8 filed with the Securities and Exchange Commission on February 20, 2015 (File No. 333-202204), and is incorporated herein by this reference.
- 10.52\* Form of Restricted Stock Unit Agreement under the Mercury General Corporation 2015 Incentive Award Plan (2016 and later version). This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on March 23, 2016, and is incorporated herein by this reference.
- 21.1 Subsidiaries of the Company. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2014, and is incorporated herein by this reference.
- 23.1

Consent of Independent Registered Public Accounting Firm.

31.1 Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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32.1 Certification of Registrant's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Annual Report on Form 10-K and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.

32.2 Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Annual Report on Form 10-K and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.

101.INS XBRL Instance Document

101.SCHXBRL Taxonomy Extension Schema Document

101.CALXBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LABXBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

\* Denotes management contract or compensatory plan or arrangement.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MERCURY GENERAL  
CORPORATION

BY/S/ GABRIEL TIRADOR  
Gabriel Tirador  
President and Chief Executive Officer  
February 9, 2017

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature   | Title   | Date                |
|---|---|---------------------|
| /S/ GEORGE JOSEPH<br>George Joseph                | Chairman of the Board   | February 9,<br>2017 |
| /S/ GABRIEL<br>TIRADOR<br>Gabriel Tirador         | President and Chief Executive Officer and Director (Principal<br>Executive Officer)                                 | February 9,<br>2017 |
| /S/ THEODORE R.<br>STALICK<br>Theodore R. Stalick | Senior Vice President and Chief Financial Officer (Principal Financial<br>Officer and Principal Accounting Officer) | February 9,<br>2017 |
| /S/ MICHAEL D.<br>CURTIUS<br>Michael D. Curtius   | Director  | February 9,<br>2017 |
| /S/ JAMES G. ELLIS<br>James G. Ellis              | Director  | February 9,<br>2017 |
| /S/ JOSHUA E. LITTLE<br>Joshua E. Little          | Director  | February 9,<br>2017 |
| /S/ MARTHA E.<br>MARCON<br>Martha E. Marcon       | Director  | February 9,<br>2017 |
| /S/ JOHN G. NACKEL<br>John G. Nackel              | Director  | February 9,<br>2017 |
| /S/ GLENN S. SCHAFER<br>Glenn S. Schafer          | Director  | February 9,<br>2017 |

/S/ DONALD R.  
SPUEHLER  
Donald R. Spuehler

Director

February 9,  
2017

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

Mercury General Corporation:

Under date of February 9, 2017, we reported on the consolidated balance sheets of Mercury General Corporation and subsidiaries (the Company) as of December 31, 2016 and 2015, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2016, as contained in the 2016 annual report on Form 10-K. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related financial statement schedules in the accompanying index. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits.

In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Los Angeles, California

February 9, 2017

See accompanying Report of Independent Registered Public Accounting Firm

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## SCHEDULE I

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
SUMMARY OF INVESTMENTS  
OTHER THAN INVESTMENTS IN RELATED PARTIES  
DECEMBER 31, 2016

| Type of Investment                 | Cost                   | Fair Value  | Amounts in the<br>Balance Sheet |
|------------------------------------|------------------------|-------------|---------------------------------|
|                                    | (Amounts in thousands) |             |                                 |
| Fixed maturity securities:         |                        |             |                                 |
| U.S. government bonds and agencies | \$12,288               | \$12,275    | \$ 12,275                       |
| Municipal securities               | 2,432,181              | 2,449,292   | 2,449,292                       |
| Mortgage-backed securities         | 39,082                 | 39,777      | 39,778                          |
| Corporate securities               | 189,780                | 189,688     | 189,688                         |
| Collateralized loan obligations    | 85,429                 | 86,525      | 86,525                          |
| Other asset-backed securities      | 36,650                 | 36,996      | 36,996                          |
| Total fixed maturity securities    | 2,795,410              | 2,814,553   | 2,814,554                       |
| Equity securities:                 |                        |             |                                 |
| Common stock                       | 286,503                | 316,450     | 316,449                         |
| Non-redeemable preferred stock     | 32,436                 | 31,809      | 31,809                          |
| Private equity funds               | 12,831                 | 9,068       | 9,068                           |
| Total equity securities            | 331,770                | 357,327     | 357,326                         |
| Short-term investments             | 375,700                | 375,680     | 375,680                         |
| Total investments                  | \$3,502,880            | \$3,547,560 | \$ 3,547,560                    |

See accompanying Report of Independent Registered Public Accounting Firm  
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## SCHEDULE I, Continued

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
SUMMARY OF INVESTMENTS  
OTHER THAN INVESTMENTS IN RELATED PARTIES  
DECEMBER 31, 2015

| Type of Investment                 | Cost                   | Fair Value  | Amounts in the<br>Balance Sheet |
|------------------------------------|------------------------|-------------|---------------------------------|
|                                    | (Amounts in thousands) |             |                                 |
| Fixed maturity securities:         |                        |             |                                 |
| U.S. government bonds and agencies | \$22,542               | \$22,507    | \$ 22,507                       |
| Municipal securities               | 2,417,046              | 2,505,039   | 2,505,039                       |
| Mortgage-backed securities         | 49,639                 | 49,839      | 49,839                          |
| Corporate securities               | 255,606                | 243,372     | 243,372                         |
| Collateralized loan obligations    | 50,710                 | 50,548      | 50,548                          |
| Other asset-backed securities      | 8,732                  | 8,698       | 8,698                           |
| Total fixed maturity securities    | 2,804,275              | 2,880,003   | 2,880,003                       |
| Equity securities:                 |                        |             |                                 |
| Common stock                       | 275,479                | 280,263     | 280,263                         |
| Non-redeemable preferred stock     | 25,161                 | 24,668      | 24,668                          |
| Private equity funds               | 12,888                 | 10,431      | 10,431                          |
| Total equity securities            | 313,528                | 315,362     | 315,362                         |
| Short-term investments             | 185,353                | 185,277     | 185,277                         |
| Total investments                  | \$3,303,156            | \$3,380,642 | \$ 3,380,642                    |

See accompanying Report of Independent Registered Public Accounting Firm  
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## SCHEDULE II

MERCURY GENERAL CORPORATION  
 CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
 BALANCE SHEETS

|   | December 31,           |             |
|---|------------------------|-------------|
|   | 2016                   | 2015        |
|   | (Amounts in thousands) |             |
| <b>ASSETS</b>   |                        |             |
| Investments, at fair value:                               |                        |             |
| Fixed maturity securities (amortized cost \$1,609; \$557) | \$1,605                | \$571       |
| Equity securities (cost \$113,943; \$131,217)             | 122,717                | 127,572     |
| Short-term investments (cost \$629; \$1,144)              | 629                    | 1,144       |
| Investment in subsidiaries                                | 1,810,663              | 1,819,426   |
| Total investments   | 1,935,614              | 1,948,713   |
| Cash  | 11,786                 | 20,139      |
| Accrued investment income                                 | 189                    | 208         |
| Amounts receivable from affiliates                        | 226                    | 220         |
| Current income taxes                                      | —                      | 8,894       |
| Deferred income taxes                                     | 2,702                  | 10,524      |
| Income tax receivable from affiliates                     | 35,237                 | 5,917       |
| Other assets  | 414                    | 2,981       |
| Total assets  | \$1,986,168            | \$1,997,596 |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>               |                        |             |
| Notes payable   | \$180,000              | \$150,000   |
| Accounts payable and accrued expenses                     | 348                    | —           |
| Amounts payable to affiliates                             | 36                     | 25          |
| Income tax payable to affiliates                          | 39,539                 | 26,439      |
| Current income taxes                                      | 10,200                 | —           |
| Other liabilities   | 3,643                  | 247         |
| Total liabilities   | 233,766                | 176,711     |
| Commitments and contingencies                             |                        |             |
| Shareholders' equity:                                     |                        |             |
| Common stock  | 95,529                 | 90,985      |
| Additional paid-in capital                                | —                      | 8,870       |
| Retained earnings   | 1,656,873              | 1,721,030   |
| Total shareholders' equity                                | 1,752,402              | 1,820,885   |
| Total liabilities and shareholders' equity                | \$1,986,168            | \$1,997,596 |

See accompanying notes to condensed financial information.  
See accompanying Report of Independent Registered Public Accounting Firm  
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## SCHEDULE II, Continued

MERCURY GENERAL CORPORATION  
 CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
 STATEMENTS OF OPERATIONS

|  | Year Ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2016                    | 2015      | 2014      |
|  | (Amounts in thousands)  |           |           |
| Revenues:  |                         |           |           |
| Net investment income  | \$4,032                 | \$4,314   | \$4,478   |
| Net realized investment gains (losses)                                     | 6,062                   | (7,026 )  | (9,428 )  |
| Other  | 17                      | —         | —         |
| Total revenues   | 10,111                  | (2,712 )  | (4,950 )  |
| Expenses:  |                         |           |           |
| Other operating expenses   | 2,673                   | 7,526     | 5,971     |
| Interest   | 2,690                   | 2,127     | 1,746     |
| Total expenses   | 5,363                   | 9,653     | 7,717     |
| Income (loss) before income taxes and equity in net income of subsidiaries | 4,748                   | (12,365 ) | (12,667 ) |
| Income tax expense (benefit)   | 8,514                   | (4,708 )  | (100 )    |
| Loss before equity in net income of subsidiaries                           | (3,766 )                | (7,657 )  | (12,567 ) |
| Equity in net income of subsidiaries                                       | 73,864                  | 82,136    | 190,516   |
| Net income   | \$70,098                | \$74,479  | \$177,949 |

See accompanying notes to condensed financial information.

See accompanying Report of Independent Registered Public Accounting Firm

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## SCHEDULE II, Continued

MERCURY GENERAL CORPORATION  
CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
STATEMENTS OF CASH FLOWS

|   | Year Ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2016                    | 2015      | 2014      |
|   | (Amounts in thousands)  |           |           |
| Cash flows from operating activities:                               |                         |           |           |
| Net cash provided by (used in) operating activities                 | \$526                   | \$548     | \$(3,434) |
| Cash flows from investing activities:                               |                         |           |           |
| Capital contribution to subsidiaries                                | (30,125)                | (90,125)  | (30,125)  |
| Distributions received from special purpose entities                | 4,898                   | 8,883     | 6,756     |
| Dividends received from subsidiaries                                | 110,800                 | 133,000   | 225,000   |
| Purchases of fixed maturity securities available for sale in nature | (1,060)                 | (571)     | —         |
| Equity securities available for sale in nature                      |                         |           |           |
| Purchases   | (64,807)                | (146,236) | (254,572) |
| Sales   | 73,942                  | 192,005   | 90,422    |
| (Decrease) in payable for securities, net                           | —                       | —         | (2,489)   |
| Net decrease in short-term investments                              | 515                     | 8,612     | 1,346     |
| Business acquisition  | —                       | (6,000)   | —         |
| Other, net  | 1,614                   | 1,945     | 2,191     |
| Net cash provided by investing activities                           | 95,777                  | 101,513   | 38,529    |
| Cash flows from financing activities:                               |                         |           |           |
| Dividends paid to shareholders                                      | (137,201)               | (136,386) | (135,496) |
| Excess tax benefit from exercise of stock options                   | 913                     | 27        | 148       |
| Proceeds from stock options exercised                               | 1,632                   | 2,111     | 6,247     |
| Proceeds from bank loan   | 30,000                  | —         | 100,000   |
| Net cash used in financing activities                               | (104,656)               | (134,248) | (29,101)  |
| Net (decrease) increase in cash                                     | (8,353)                 | (32,187)  | 5,994     |
| Cash:   |                         |           |           |
| Beginning of year   | 20,139                  | 52,326    | 46,332    |
| End of year   | \$11,786                | \$20,139  | \$52,326  |
| SUPPLEMENTAL CASH FLOW DISCLOSURE                                   |                         |           |           |
| Interest paid   | \$2,397                 | \$2,153   | \$1,757   |
| Income taxes (refunded) paid  | \$(339)                 | \$1,807   | \$2,112   |

See accompanying notes to condensed financial information.

See accompanying Report of Independent Registered Public Accounting Firm

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MERCURY GENERAL CORPORATION  
CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
NOTES TO CONDENSED FINANCIAL INFORMATION

The accompanying condensed financial information should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in this report.

Distributions received from Special Purpose Entities

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle, formed by and consolidated into the Company, entered into a total return swap agreement with Citibank. Under the total return swap agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$30 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest equal to LIBOR plus 145 basis points on approximately \$108 million and \$95 million of underlying obligations as of December 31, 2016 and 2015, respectively. The agreement had an initial term of one year, subject to annual renewal. In January 2017, the agreement was renewed for an additional year expiring February 17, 2018, and the interest rate was changed to LIBOR plus 128 basis points.

On August 9, 2013, Animas Funding LLC ("AFL"), a special purpose investment vehicle, formed and consolidated by the Company, entered into a three-year total return swap agreement with Citibank, which has been renewed for an additional one-year term through February 17, 2018. Under the total return swap agreement, AFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$40 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest equal to LIBOR plus 135 basis points on approximately \$152 million and \$124 million of underlying obligations as of December 31, 2016 and 2015, respectively. The agreement was amended in January 2017 and the interest rate was changed to LIBOR plus 128 basis points.

Distributions of \$4.9 million and \$8.9 million were received in 2016 and 2015, respectively, from these special purpose entities.

Dividends received from Subsidiaries

Dividends of \$110,800,000, \$133,000,000 and \$225,000,000 were received by Mercury General from its 100% owned insurance subsidiaries in 2016, 2015 and 2014, respectively, and are recorded as a reduction to investment in subsidiaries.

Capitalization of Insurance Subsidiaries

Mercury General made capital contributions to its insurance subsidiaries of \$30,125,000, \$90,125,000 and \$30,125,000 in 2016, 2015 and 2014, respectively.

Business Acquisition

Pursuant to an October 22, 2014 Stock Purchase Agreement, Mercury General purchased all the issued and outstanding shares of Workmen's Auto Insurance Company ("WAIC"), a California domiciled property and casualty insurance company, on January 2, 2015.

WAIC is a Los Angeles-based non-standard, private passenger automobile insurance company that operates predominantly in California. Mercury General intends to use the WAIC non-standard automobile product to complement its preferred and standard product offerings.

The Company paid \$8 million in cash for the shares of WAIC, of which \$2 million has been held in escrow for up to three years as security for any loss development on claims incurred on or prior to June 30, 2014. Based on the evaluation performed at the acquisition date and at December 31, 2015, of the claims reserves for WAIC for losses and loss adjustment expenses incurred on or prior to June 30, 2014, the Company estimated that it would recover the \$2 million held in escrow and, therefore, the Company deducted it from cash consideration to arrive at the fair value

of total consideration transferred. The Company recovered the \$2 million held in escrow in 2016. In accordance with regulatory approval requirements, the Company made a \$15 million cash capital contribution to WAIC on January 12, 2015.

See accompanying Report of Independent Registered Public Accounting Firm  
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Notes Payable

On July 2, 2013, Mercury General entered into an unsecured \$200 million five-year revolving credit facility. Effective December 3, 2014, the Company expanded the borrowing capacity from \$200 million to \$250 million. Total borrowings were \$180 million under the credit facility as of December 31, 2016. The interest rate was approximately 1.73% at December 31, 2016.

Commitments and Contingencies

The borrowings by MCC, a subsidiary, under the \$120 million credit facility and \$20 million bank loan are secured by approximately \$175 million of municipal bonds owned by MCC, at fair value, held as collateral. The total borrowings of \$140 million are guaranteed by Mercury General.

Federal Income Taxes

The Company files a consolidated federal income tax return for the following entities:

- |   |   |
|---|---|
| Mercury Casualty Company                                | Mercury County Mutual Insurance Company |
| Mercury Insurance Company                               | Mercury Insurance Company of Florida    |
| California Automobile Insurance Company                 | Mercury Indemnity Company of America    |
| California General Underwriters Insurance Company, Inc. | Mercury Select Management Company, Inc. |
| Mercury Insurance Company of Illinois                   | Mercury Insurance Services LLC          |
| Mercury Insurance Company of Georgia                    | AIS Management LLC                      |
| Mercury Indemnity Company of Georgia                    | Auto Insurance Specialists LLC          |
| Mercury National Insurance Company                      | PoliSeek AIS Insurance Solutions, Inc.  |
| American Mercury Insurance Company                      | Animas Funding LLC                      |
| American Mercury Lloyds Insurance Company               | Fannette Funding LLC                    |
| Workmen's Auto Insurance Company                        |   |

The method of allocation between the companies is subject to an agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses incurred by the insurance subsidiaries to the extent it can be used in the current consolidated return.

SCHEDULE IV  
 MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
 REINSURANCE  
 THREE YEARS ENDED DECEMBER 31,  
 Property and Liability Insurance Earned Premiums

|                          | 2016                   | 2015        | 2014        |
|--------------------------|------------------------|-------------|-------------|
|                          | (Amounts in thousands) |             |             |
| Direct amounts           | \$3,146,864            | \$2,970,424 | \$2,806,889 |
| Ceded to other companies | (15,846 )              | (12,964 )   | (11,185 )   |
| Assumed                  | 755                    | 437         | 491         |
| Net amounts              | \$3,131,773            | \$2,957,897 | \$2,796,195 |

See accompanying Report of Independent Registered Public Accounting Firm  
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