

ERIE INDEMNITY CO  
Form 10-Q  
October 31, 2013  
Table of Contents

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2013

Commission file number 0-24000

ERIE INDEMNITY COMPANY  
(Exact name of registrant as specified in its charter)

PENNSYLVANIA (State or other jurisdiction of incorporation or organization)	25-0466020 (I.R.S. Employer Identification No.)
---	---

100 Erie Insurance Place, Erie, Pennsylvania (Address of principal executive offices)	16530 (Zip Code)
--	---------------------

(814) 870-2000  
(Registrant's telephone number, including area code)

Not applicable  
(Former name, former address and former fiscal year, if changed since last  
report)

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 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  
Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller Reporting Company

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes      No    X

The number of shares outstanding of the registrant's Class A Common Stock as of the latest practicable date, with no par value and a stated value of \$0.0292 per share, was 46,563,694 at October 18, 2013.

The number of shares outstanding of the registrant's Class B Common Stock as of the latest practicable date, with no par value and a stated value of \$70 per share, was 2,542 at October 18, 2013.

---

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Consolidated Statements of Operations – Three and nine months ended September 30, 2013 and 2012

Consolidated Statements of Comprehensive Income – Three and nine months ended September 30, 2013 and 2012

Consolidated Statements of Financial Position – September 30, 2013 and December 31, 2012

Consolidated Statements of Cash Flows – Nine months ended September 30, 2013 and 2012

Notes to Consolidated Financial Statements – September 30, 2013

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Item 1A. Risk Factors

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

Item 5. Other Information

Item 6. Exhibits

SIGNATURES

Table of ContentsPART I. FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTSERIE INDEMNITY COMPANY  
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)  
(dollars in millions, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Revenues				
Premiums earned	\$1,241	\$1,137	\$3,631	\$3,333
Net investment income	109	105	316	326
Net realized investment gains	191	169	501	358
Net impairment losses recognized in earnings	(9	) 0	(10	) 0
Equity in earnings of limited partnerships	37	41	112	99
Other income	8	8	24	24
Total revenues	1,577	1,460	4,574	4,140
Benefits and expenses				
Insurance losses and loss expenses	868	912	2,571	2,571
Policy acquisition and underwriting expenses	311	278	906	835
Total benefits and expenses	1,179	1,190	3,477	3,406
Income from operations before income taxes and noncontrolling interest	398	270	1,097	734
Provision for income taxes	131	86	363	234
Net income	\$267	\$184	\$734	\$500
Less: Net income attributable to noncontrolling interest in consolidated entity – Exchange	221	133	607	370
Net income attributable to Indemnity	\$46	\$51	\$127	\$130
Earnings Per Share				
Net income attributable to Indemnity per share				
Class A common stock – basic	\$0.98	\$1.08	\$2.71	\$2.73
Class A common stock – diluted	\$0.87	\$0.96	\$2.41	\$2.43
Class B common stock – basic and diluted	\$147	\$162	\$406	\$411
Weighted average shares outstanding attributable to Indemnity – Basic				
Class A common stock	46,656,911	47,188,741	46,707,971	47,476,693
Class B common stock	2,542	2,544	2,542	2,544
Weighted average shares outstanding attributable to Indemnity – Diluted				
Class A common stock	52,851,250	53,374,846	52,902,310	53,662,798
Class B common stock	2,542	2,544	2,542	2,544

Dividends declared per share				
Class A common stock	\$0.5925	\$0.5525	\$1.7775	\$1.6575
Class B common stock	\$88.8750	\$82.8750	\$266.6250	\$248.6250

See accompanying notes to Consolidated Financial Statements. See Note 12. "Indemnity Accumulated Other Comprehensive Loss," for amounts reclassified out of accumulated other comprehensive income (loss) into the Consolidated Statements of Operations. See Note 15. "Indemnity Supplemental Information," for supplemental statements of operations information.

Table of Contents

ERIE INDEMNITY COMPANY  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)  
 (in millions)

	Three months ended		Nine months ended		
	September 30,		September 30,		
	2013	2012	2013	2012	
Net income	\$267	\$184	\$734	\$500	
Other comprehensive (loss) income					
Change in unrealized holding (losses) gains on available-for-sale securities, net of tax (benefit) expense of \$(12), \$59, \$(123), and \$112, respectively	(23	) 110	(229	) 208	
Reclassification adjustment for gross losses (gains) included in net income, net of tax (benefit) expense of \$(12), \$5, \$(5), and \$13, respectively	21	(11	) 8	(25	)
Other comprehensive (loss) income	(2	) 99	(221	) 183	
Comprehensive income	\$265	\$283	\$513	\$683	
Less: Comprehensive income attributable to noncontrolling interest in consolidated entity – Exchange	221	230	393	549	
Total comprehensive income – Indemnity	\$44	\$53	\$120	\$134	

See accompanying notes to Consolidated Financial Statements. See Note 12. "Indemnity Accumulated Other Comprehensive Loss," for supplemental statements of comprehensive income (loss) information.

Table of Contents

ERIE INDEMNITY COMPANY  
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION  
(dollars in millions, except per share data)

	September 30, 2013 (Unaudited)	December 31, 2012
Assets		
Investments – Indemnity		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of \$491 and \$437, respectively)	\$499	\$452
Equity securities (cost of \$48 and \$54, respectively)	48	55
Limited partnerships (cost of \$133 and \$151, respectively)	158	180
Other invested assets	1	1
Investments – Exchange		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of \$7,541 and \$7,016, respectively)	7,921	7,707
Equity securities (cost of \$809 and \$871, respectively)	849	945
Trading securities, at fair value (cost of \$2,157 and \$1,910, respectively)	2,945	2,417
Limited partnerships (cost of \$836 and \$913, respectively)	979	1,037
Other invested assets	20	20
Total investments	13,420	12,814
Cash and cash equivalents (Exchange portion of \$502 and \$388, respectively)	535	400
Premiums receivable from policyholders – Exchange	1,203	1,062
Reinsurance recoverable – Exchange	174	168
Deferred income taxes – Indemnity	42	37
Deferred acquisition costs – Exchange	574	504
Other assets (Exchange portion of \$329 and \$339, respectively)	436	456
Total assets	\$16,384	\$15,441
Liabilities and shareholders' equity		
Liabilities		
Indemnity liabilities		
Other liabilities	\$574	\$515
Exchange liabilities		
Losses and loss expense reserves	3,712	3,598
Life policy and deposit contract reserves	1,754	1,708
Unearned premiums	2,654	2,365
Deferred income taxes	368	365
Other liabilities	123	99
Total liabilities	9,185	8,650
Indemnity shareholders' equity		
Class A common stock, stated value \$0.0292 per share; 74,996,930 shares authorized; 68,299,200 shares issued; 46,603,257 and 46,892,681 shares outstanding, respectively	2	2
Class B common stock, convertible at a rate of 2,400 Class A shares for one Class B share, stated value \$70 per share; 3,070 shares authorized; 2,542 shares issued and outstanding	0	0
Additional paid-in-capital	16	16

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Accumulated other comprehensive loss	(140	) (133	)
Retained earnings	1,896	1,852	
Total contributed capital and retained earnings	1,774	1,737	
Treasury stock, at cost, 21,695,943 and 21,406,519 shares, respectively	(1,117	) (1,095	)
Total Indemnity shareholders' equity	657	642	
Noncontrolling interest in consolidated entity – Exchange	6,542	6,149	
Total equity	7,199	6,791	
Total liabilities, shareholders' equity and noncontrolling interest	\$ 16,384	\$ 15,441	

See accompanying notes to Consolidated Financial Statements. See Note 15. “Indemnity Supplemental Information,” for supplemental consolidating statements of financial position information.



Table of Contents

ERIE INDEMNITY COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(in millions)

	Nine months ended September 30,	
	2013	2012
Cash flows from operating activities		
Premiums collected	\$3,780	\$3,452
Net investment income received	337	346
Limited partnership distributions	125	94
Service agreement fee received	23	23
Commissions and bonuses paid to agents	(521)	(470)
Losses paid	(2,039)	(2,050)
Loss expenses paid	(343)	(352)
Other underwriting and acquisition costs paid	(465)	(432)
Income taxes paid	(208)	(246)
Net cash provided by operating activities	689	365
Cash flows from investing activities		
Purchase of investments:		
Fixed maturities	(2,157)	(1,466)
Preferred stock	(94)	(118)
Common stock	(1,021)	(750)
Limited partnerships	(66)	(64)
Sales/maturities of investments:		
Fixed maturity sales	716	535
Fixed maturity calls/maturities	881	877
Preferred stock	84	106
Common stock	1,057	733
Sale of and returns on limited partnerships	125	141
Net purchase of property and equipment	(24)	(27)
Net collections on agent loans	1	0
Net distributions on life policy loans	0	(1)
Net cash used in investing activities	(498)	(34)
Cash flows from financing activities		
Annuity deposits and interest	68	72
Annuity surrenders and withdrawals	(58)	(59)
Universal life deposits and interest	20	17
Universal life surrenders	(8)	(7)
Purchase of treasury stock	(22)	(55)
Dividends paid to shareholders	(56)	(80)
Net cash used in financing activities	(56)	(112)
Net increase in cash and cash equivalents	135	219
Cash and cash equivalents at beginning of period	400	185
Cash and cash equivalents at end of period	\$535	\$404

See accompanying notes to Consolidated Financial Statements. See Note 15. "Indemnity Supplemental Information," for supplemental cash flow information.

6

---

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Nature of Operations

Erie Indemnity Company (“Indemnity”) is a publicly held Pennsylvania business corporation that has been the managing attorney-in-fact for the subscribers (policyholders) at the Erie Insurance Exchange (“Exchange”) since 1925. The Exchange is a subscriber-owned, Pennsylvania-domiciled reciprocal insurer that writes property and casualty insurance.

Indemnity’s primary function is to perform certain services for the Exchange relating to the sales, underwriting and issuance of policies on behalf of the Exchange. This is done in accordance with a subscriber’s agreement (a limited power of attorney) executed by each subscriber (policyholder), which appoints Indemnity as their common attorney-in-fact to transact business on their behalf and to manage the affairs of the Exchange. Pursuant to the subscriber’s agreement and for its services as attorney-in-fact, Indemnity earns a management fee calculated as a percentage of the direct premiums written by the Exchange and the other members of the Property and Casualty Group (defined below), which are assumed by the Exchange under an intercompany pooling arrangement.

Indemnity has the power to direct the activities of the Exchange that most significantly impact the Exchange’s economic performance by acting as the common attorney-in-fact and decision maker for the subscribers (policyholders) at the Exchange.

The Exchange, together with its wholly owned subsidiaries, Erie Insurance Company (“EIC”), Erie Insurance Company of New York (“ENY”), Erie Insurance Property and Casualty Company (“EPC”), and Flagship City Insurance Company (“Flagship”), operate as a property and casualty insurer and are collectively referred to as the “Property and Casualty Group”. The Property and Casualty Group operates in 11 Midwestern, Mid-Atlantic and Southeastern states and the District of Columbia.

Erie Family Life Insurance Company (“EFL”), a wholly owned subsidiary of the Exchange, operates as a life insurer that underwrites and sells individual and group life insurance policies and fixed annuities.

Indemnity plans to expand the property and casualty and life insurance operations of the Erie Insurance Group into the Commonwealth of Kentucky by early 2015.

All property and casualty and life insurance operations are owned by the Exchange and Indemnity functions solely as the management company.

The consolidated financial statements of Erie Indemnity Company reflect the results of Indemnity and its variable interest entity, the Exchange, which we refer to collectively as the “Erie Insurance Group” (“we,” “us,” “our”).

“Indemnity shareholder interest” refers to the interest in Erie Indemnity Company owned by the Class A and Class B shareholders. “Noncontrolling interest” refers to the interest in the Erie Insurance Exchange held for the subscribers (policyholders).

Note 2. Significant Accounting Policies

Basis of presentation

The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) and include the accounts of Indemnity together with its affiliate companies in which

Indemnity holds a majority voting or economic interest.

Use of estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods have been included. Operating results for the nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ended December 31, 2013. The accompanying consolidated financial statements and notes should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission on February 26, 2013.

## Table of Contents

### Principles of consolidation

We consolidate the Exchange as a variable interest entity for which Indemnity is the primary beneficiary. All intercompany accounts and transactions have been eliminated in consolidation. The required presentation of noncontrolling interests is reflected in the consolidated financial statements. Noncontrolling interests represent the ownership interests of the Exchange, all of which are held by parties other than Indemnity (i.e. the Exchange's subscribers (policyholders)). Noncontrolling interests also include the Exchange subscribers' ownership interest in EFL.

**Presentation of assets and liabilities** – While the assets of the Exchange are presented separately in the Consolidated Statements of Financial Position, the Exchange's assets can only be used to satisfy the Exchange's liabilities or for other unrestricted activities. Accounting Standards Codification ("ASC") 810, Consolidation, does not require separate presentation of the Exchange's assets; however, because the shareholders of Indemnity have no rights to the assets of the Exchange and, conversely, the Exchange has no rights to the assets of Indemnity, we have presented the invested assets of the Exchange separately on the Consolidated Statements of Financial Position along with the remaining consolidated assets reflecting the Exchange's portion parenthetically. Liabilities are required under ASC 810, Consolidation, to be presented separately for the Exchange on the Consolidated Statements of Financial Position as the Exchange's creditors do not have recourse to the general credit of Indemnity.

**Rights of shareholders of Indemnity and subscribers (policyholders) of the Exchange** – The shareholders of Indemnity, through the management fee, have a controlling financial interest in the Exchange; however, they have no other rights to or obligations arising from assets and liabilities of the Exchange. The shareholders of Indemnity own its equity but have no rights or interest in the Exchange's (noncontrolling interest) income or equity. The noncontrolling interest equity represents the Exchange's equity held for the interest of its subscribers (policyholders), who have no rights or interest in the Indemnity shareholder interest income or equity.

All intercompany assets, liabilities, revenues and expenses between Indemnity and the Exchange have been eliminated in the Consolidated Financial Statements.

### Adopted accounting pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendments in this ASU require an entity to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the line items affected by the reclassification. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other related disclosures for additional information. ASU 2013-02 is effective prospectively for interim and annual periods beginning after December 15, 2012. We have elected to present amounts reclassified out of accumulated other comprehensive income by component and the respective line items of net income in the notes to our consolidated financial statements. See Note 12. "Indemnity's Accumulated Other Comprehensive Loss".

### Pending accounting pronouncements

In February 2013, the FASB issued ASU 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date. The amendments in this ASU provide guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this guidance is fixed at the reporting date, except for obligations addressed within existing guidance in GAAP. ASU 2013-04 is effective for interim and annual periods beginning after December 15, 2013, with early adoption permitted. We do not expect the adoption of this new guidance to have a material impact on our consolidated financial statements.



Table of Contents

## Note 3. Indemnity Earnings Per Share

Class A and Class B basic earnings per share and Class B diluted earnings per share are calculated under the two-class method. The two-class method allocates earnings to each class of stock based upon its dividend rights. Class B shares are convertible into Class A shares at a conversion ratio of 2,400 to 1. See Note 11. "Indemnity Capital Stock".

Class A diluted earnings per share are calculated under the if-converted method, which reflects the conversion of Class B shares to Class A shares. Diluted earnings per share calculations include the effect of any potential common shares. Potential common shares include outstanding vested and not yet vested awards related to our outside directors' stock compensation plan and any employee stock based awards.

A reconciliation of the numerators and denominators used in the basic and diluted per-share computations is presented as follows for each class of Indemnity common stock:

(dollars in millions, except per share data)	Indemnity Shareholder Interest					
	Three months ended September 30,					
	2013			2012		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per- share amount
<b>Class A – Basic EPS:</b>						
Income available to Class A stockholders	\$46	46,656,911	\$0.98	\$51	47,188,741	\$1.08
Dilutive effect of stock-based awards	0	93,539	—	0	80,505	—
Assumed conversion of Class B shares	0	6,100,800	—	0	6,105,600	—
<b>Class A – Diluted EPS:</b>						
Income available to Class A stockholders on Class A equivalent shares	\$46	52,851,250	\$0.87	\$51	53,374,846	\$0.96
<b>Class B – Basic and diluted EPS:</b>						
Income available to Class B stockholders	\$0	2,542	\$147	\$0	2,544	\$162

(dollars in millions, except per share data)	Indemnity Shareholder Interest					
	Nine months ended September 30,					
	2013			2012		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per- share amount
<b>Class A – Basic EPS:</b>						
Income available to Class A stockholders	\$126	46,707,971	\$2.71	\$129	47,476,693	\$2.73
Dilutive effect of stock-based awards	0	93,539	—	0	80,505	—

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Assumed conversion of Class B shares	1	6,100,800	—	1	6,105,600	—
Class A – Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	\$ 127	52,902,310	\$ 2.41	\$ 130	53,662,798	\$ 2.43
Class B – Basic and diluted EPS:						
Income available to Class B stockholders	\$ 1	2,542	\$ 406	\$ 1	2,544	\$ 411

9

---



Table of Contents

Note 4. Variable Interest Entity

Erie Insurance Exchange

The Exchange is a reciprocal insurance exchange domiciled in Pennsylvania, for which Indemnity serves as attorney-in-fact. Indemnity holds a variable interest in the Exchange due to the absence of decision-making capabilities by the equity owners (subscribers/policyholders) of the Exchange and due to the significance of the management fee the Exchange pays to Indemnity as its decision maker. As a result, Indemnity is deemed to have a controlling financial interest in the Exchange and is considered to be its primary beneficiary.

Consolidation of the Exchange's financial results is required given the significance of the management fee to the Exchange and because Indemnity has the power to direct the activities of the Exchange that most significantly impact the Exchange's economic performance. The Exchange's anticipated economic performance is the product of its underwriting results combined with its investment results. The fees paid to Indemnity under the subscriber's agreement impact the anticipated economic performance attributable to the Exchange's results. Indemnity earns a management fee from the Exchange for the services it provides as attorney-in-fact. Indemnity's management fee revenues are based on all premiums written or assumed by the Exchange. Indemnity's Board of Directors determines the management fee rate to be paid by the Exchange to Indemnity. This rate cannot exceed 25% of the direct and assumed written premiums of the Exchange, as defined by the subscriber's agreement signed by each policyholder. Management fee revenues and management fee expenses are eliminated upon consolidation.

The shareholders of Indemnity have no rights to the assets of the Exchange and no obligations arising from the liabilities of the Exchange. Indemnity has no obligation related to any underwriting and/or investment losses experienced by the Exchange. Indemnity would, however, be adversely impacted if the Exchange incurred significant underwriting and/or investment losses. If the surplus of the Exchange were to decline significantly from its current level, its financial strength ratings could be reduced and, as a consequence, the Exchange could find it more difficult to retain its existing business and attract new business. A decline in the business of the Exchange would have an adverse effect on the amount of the management fees Indemnity receives. In addition, a decline in the surplus of the Exchange from its current level may impact the management fee rate received by Indemnity. Indemnity also has an exposure to a concentration of credit risk related to the unsecured receivables due from the Exchange for its management fee. If any of these events occurred, Indemnity's financial position, financial performance and/or cash flows could be adversely impacted.

All property and casualty and life insurance operations are owned by the Exchange, and Indemnity functions solely as the management company.

Indemnity has not provided financial or other support to the Exchange for any the reporting periods presented. At September 30, 2013, there are no explicit or implicit arrangements that would require Indemnity to provide future financial support to the Exchange. Indemnity is not liable if the Exchange was to be in violation of its debt covenants or was unable to meet its obligation for unfunded commitments to limited partnerships.

Table of Contents

Note 5. Segment Information

Our reportable segments include management operations, property and casualty insurance operations, life insurance operations and investment operations. Accounting policies for segments are the same as those described in the summary of significant accounting policies. See Item 8. "Financial Statements and Supplementary Data, Note 2. Significant Accounting Policies," in our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission on February 26, 2013. Assets are not allocated to the segments, but rather, are reviewed in total for purposes of decision-making. No single customer or agent provides 10% or more of revenues.

Management operations

Our management operations segment consists of Indemnity serving as attorney-in-fact for the Exchange. Indemnity operates in this capacity solely for the Exchange. We evaluate profitability of our management operations segment principally on the gross margin from management operations. Indemnity earns a management fee from the Exchange for providing sales, underwriting and policy issuance services. Management fee revenue, which is eliminated upon consolidation, is calculated as a percentage not to exceed 25% of all the direct premiums written by the Exchange and the other members of the Property and Casualty Group, which are assumed by the Exchange under an intercompany pooling arrangement. The Property and Casualty Group issues policies with annual terms only. Management fees are recorded upon policy issuance or renewal, as substantially all of the services required to be performed by Indemnity have been satisfied at that time. Certain activities are performed and related costs are incurred by us subsequent to policy issuance in connection with the services provided to the Exchange; however, these activities are inconsequential and perfunctory. Although these management fee revenues and expenses are eliminated upon consolidation, the amount of the fee directly impacts the allocation of our consolidated net income between the noncontrolling interest, which bears the management fee expense and represents the interests of the Exchange subscribers (policyholders), and Indemnity's interest, which earns the management fee revenue and represents the Indemnity shareholder interest in net income.

Additionally, the nine months ended September 30, 2012 included an adjustment that reduced commission expense by \$6 million which occurred in the second quarter of 2012. This amount represents the reimbursement by the North Carolina Reinsurance Facility (NCRF) for commissions Indemnity paid to agents on the surcharges collected on behalf of the NCRF which was incorrectly recorded as a benefit to the Exchange in prior periods.

Property and casualty insurance operations

Our property and casualty insurance operations segment includes personal and commercial lines. Personal lines consist primarily of personal auto and homeowners and are marketed to individuals. Commercial lines consist primarily of commercial multi-peril, commercial auto and workers compensation and are marketed to small- and medium-sized businesses. Our property and casualty policies are sold by independent agents. Our property and casualty insurance underwriting operations are conducted through the Exchange and its subsidiaries and include assumed voluntary reinsurance from nonaffiliated domestic and foreign sources, assumed involuntary and ceded reinsurance business. The Exchange exited the assumed voluntary reinsurance business effective December 31, 2003, and therefore unaffiliated reinsurance includes only run-off activity of the previously assumed voluntary reinsurance business. We evaluate profitability of the property and casualty insurance operations principally based upon net underwriting results represented by the combined ratio.

Life insurance operations

Our life insurance operations segment includes traditional and universal life insurance products and fixed annuities marketed to individuals using the same independent agency force utilized by our property and casualty insurance operations. We evaluate profitability of the life insurance segment principally based upon segment net income, including investments, which for segment purposes are reflected in the investment operations segment. At the same

time, we recognize that investment-related income is integral to the evaluation of the life insurance segment because of the long duration of life products. For the third quarters of 2013 and 2012, investment activities on life insurance related assets generated revenues of \$26 million and \$25 million, respectively, resulting in EFL reporting income before income taxes of \$10 million and \$12 million, respectively, before intercompany eliminations. For the nine months ended September 30, 2013 and 2012, investment activities on life insurance related assets generated revenues of \$78 million and \$77 million, respectively, resulting in EFL reporting income before income taxes of \$34 million for both periods, before intercompany eliminations.

#### Investment operations

The investment operations segment includes returns from our fixed maturity, equity security and limited partnership investment portfolios to support our underwriting business. The Indemnity and Exchange portfolios are managed with the objective of maximizing after-tax returns on a risk-adjusted basis, while the EFL portfolio is managed to be closely aligned to its liabilities and to maintain a sufficient yield to meet profitability targets. Management actively evaluates the portfolios for impairments. We record impairment writedowns on investments in instances where the fair value of the investment is substantially below cost, and we conclude that the decline in fair value is other-than-temporary. Investment related income for the life operations is included in the investment segment results.

Table of Contents

The following tables summarize the components of the Consolidated Statements of Operations by reportable business segment:

(in millions)	Erie Insurance Group Three months ended September 30, 2013					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$1,221	\$21			\$(1 )	\$ 1,241
Net investment income				\$111		(2 )	109
Net realized investment gains				191			191
Net impairment losses recognized in earnings				(9 )			(9 )
Equity in earnings of limited partnerships				37			37
Management fee revenue	\$333					(333 )	—
Service agreement and other revenue	8		0				8
Total revenues	341	1,221	21	330		(336 )	1,577
Cost of management operations	281					(281 )	—
Insurance losses and loss expenses		841	28			(1 )	868
Policy acquisition and underwriting expenses		356	9			(54 )	311
Total benefits and expenses	281	1,197	37	—		(336 )	1,179
Income (loss) before income taxes	60	24	(16 )	330		—	398
Provision for income taxes	21	8	(5 )	107		—	131
Net income (loss)	\$39	\$16	\$(11 )	\$223		—	\$ 267

(in millions)	Erie Insurance Group Three months ended September 30, 2012					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$1,118	\$19			\$0	\$ 1,137
Net investment income				\$108		(3 )	105
Net realized investment gains				169			169
Net impairment losses recognized in earnings				0			0
Equity in earnings of limited partnerships				41			41
Management fee revenue	\$305					(305 )	—
Service agreement and other revenue	8		0				8
Total revenues	313	1,118	19	318		(308 )	1,460
Cost of management operations	247					(247 )	—
Insurance losses and loss expenses		890	24			(2 )	912

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Policy acquisition and underwriting expense		329	8		(59	) 278
Total benefits and expenses	247	1,219	32	—	(308	) 1,190
Income (loss) before income taxes	66	(101	) (13	) 318	—	270
Provision for income taxes	23	(36	) (4	) 103	—	86
Net income (loss)	\$43	\$(65	) \$(9	) \$215	\$—	\$ 184

12

---

Table of Contents

(in millions)	Erie Insurance Group					Eliminations	Consolidated
	Nine months ended September 30, 2013						
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$3,573	\$60		\$ (2	)	\$ 3,631
Net investment income				\$324	(8	)	316
Net realized investment gains				501			501
Net impairment losses recognized in earnings				(10	)		(10
Equity in earnings of limited partnerships				112			112
Management fee revenue	\$965				(965	)	—
Service agreement and other revenue	23		1				24
Total revenues	988	3,573	61	927	(975	)	4,574
Cost of management operations	820				(820	)	—
Insurance losses and loss expenses		2,495	80		(4	)	2,571
Policy acquisition and underwriting expenses		1,032	25		(151	)	906
Total benefits and expenses	820	3,527	105	—	(975	)	3,477
Income (loss) before income taxes	168	46	(44	)	927	—	1,097
Provision for income taxes	59	16	(15	)	303	—	363
Net income (loss)	\$109	\$30	\$(29	)	\$624	\$—	\$734

(in millions)	Erie Insurance Group					Eliminations	Consolidated
	Nine months ended September 30, 2012						
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$3,279	\$55		\$ (1	)	\$ 3,333
Net investment income				\$334	(8	)	326
Net realized investment gains				358			358
Net impairment losses recognized in earnings				0			0
Equity in earnings of limited partnerships				99			99
Management fee revenue	\$882				(882	)	—
Service agreement and other revenue	23		1				24
Total revenues	905	3,279	56	791	(891	)	4,140
Cost of management operations	734				(734	)	—
Insurance losses and loss expenses		2,501	74		(4	)	2,571
Policy acquisition and underwriting expenses		963	25		(153	)	835

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Total benefits and expenses	734	3,464	99	—	(891	) 3,406
Income (loss) before income taxes	171	(185	) (43	) 791	—	734
Provision for income taxes	60	(65	) (15	) 254	—	234
Net income (loss)	\$111	\$(120	) \$(28	) \$537	\$—	\$ 500

Table of Contents

Note 6. Fair Value

Our available-for-sale and trading securities are recorded at fair value, which is the price that would be received to sell the asset in an orderly transaction between willing market participants as of the measurement date.

Valuation techniques used to derive the fair value of our available-for-sale and trading securities are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect our own assumptions regarding fair market value for these securities. Although the majority of our prices are obtained from third party sources, we also perform an internal pricing review for securities with low trading volumes under current market conditions. Financial instruments are categorized based upon the following characteristics or inputs to the valuation techniques:

• Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

• Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

• Level 3 – Unobservable inputs for the asset or liability.

Estimates of fair values for our investment portfolio are obtained primarily from a nationally recognized pricing service. Our Level 1 category includes those securities valued using an exchange traded price provided by the pricing service. The methodologies used by the pricing service that support a Level 2 classification of a financial instrument include multiple verifiable, observable inputs including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. Pricing service valuations for Level 3 securities are based upon proprietary models and are used when observable inputs are not available or in illiquid markets.

In limited circumstances we adjust the price received from the pricing service when, in our judgment, a better reflection of fair value is available based upon corroborating information and our knowledge and monitoring of market conditions such as a disparity in price of comparable securities and/or non-binding broker quotes. In other circumstances, certain securities are internally priced because prices are not provided by the pricing service.

We perform continuous reviews of the prices obtained from the pricing service. This includes evaluating the methodology and inputs used by the pricing service to ensure that we determine the proper classification level of the financial instrument. Price variances, including large periodic changes, are investigated and corroborated by market data. We have reviewed the pricing methodologies of our pricing service as well as other observable inputs, such as data, and transaction volumes and believe that their prices adequately consider market activity in determining fair value. Our review process continues to evolve based upon accounting guidance and requirements.

When a price from the pricing service is not available, values are determined by obtaining broker/dealer quotes and/or market comparables. When available, we obtain multiple quotes for the same security. The ultimate value for these securities is determined based upon our best estimate of fair value using corroborating market information. Our evaluation includes the consideration of benchmark yields, reported trades, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data.

For certain securities in an illiquid market, there may be no prices available from a pricing service and no comparable market quotes available. In these situations, we value the security using an internally-developed, risk-adjusted discounted cash flow model.





Table of Contents

The following table represents our consolidated fair value measurements on a recurring basis by asset class and level of input at September 30, 2013:

(in millions)	Erie Insurance Group September 30, 2013 Fair value measurements using:			
	Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
<b>Indemnity</b>				
Available-for-sale securities:				
States & political subdivisions	\$219	\$0	\$219	\$0
Corporate debt securities	279	0	278	1
Collateralized debt obligations	1	0	0	1
Total fixed maturities	499	0	497	2
Nonredeemable preferred stock	23	2	21	0
Common stock	25	25	0	0
Total available-for-sale securities	547	27	518	2
Other investments <sup>(1)</sup>	19	0	0	19
Total – Indemnity	\$566	\$27	\$518	\$21
<b>Exchange</b>				
Available-for-sale securities:				
U.S. government & agencies	\$173	\$0	\$173	\$0
States & political subdivisions	1,431	0	1,431	0
Foreign government securities	15	0	15	0
Corporate debt securities	5,969	0	5,943	26
Residential mortgage-backed securities	199	0	199	0
Commercial mortgage-backed securities	48	0	48	0
Collateralized debt obligations	20	0	11	9
Other debt securities	66	0	66	0
Total fixed maturities	7,921	0	7,886	35
Nonredeemable preferred stock	611	230	381	0
Common stock	238	238	0	0
Total available-for-sale securities	8,770	468	8,267	35
Trading securities:				
Common stock	2,945	2,931	0	14
Total trading securities	2,945	2,931	0	14
Other investments <sup>(1)</sup>	100	0	0	100
Total – Exchange	\$11,815	\$3,399	\$8,267	\$149
Total – Erie Insurance Group	\$12,381	\$3,426	\$8,785	\$170

(1) Other investments measured at fair value represent four real estate funds included on the balance sheet as limited partnership investments that are reported under the fair value option. These investments can never be redeemed with the funds. Instead, distributions are received when liquidation of the underlying assets of the funds occur. It is estimated that the underlying assets will generally be liquidated between 5 and 10 years from the inception of the funds. The fair value of these investments is based on the net asset value (NAV) information provided by the

general partner. Fair value is based on our proportionate share of the NAV based on the most recent partners' capital statements received from the general partners, which is generally one quarter prior to our balance sheet date. These values are then analyzed to determine if they represent the NAV at our balance sheet date, with adjustment being made where appropriate. We consider observable market data and perform a review validating the appropriateness of the NAV at each balance sheet date. It is likely that all of the investments will be redeemed at a future date for an amount different than the NAV of our ownership interest in partners' capital as of September 30, 2013. During the nine months ended September 30, 2013, Indemnity made no contributions and received distributions totaling \$1.4 million, and the Exchange made no contributions and received distributions totaling \$18.3 million for these investments. As of September 30, 2013, the amount of unfunded commitments related to the investments was \$1.5 million for Indemnity and \$4.5 million for the Exchange.

Table of Contents

## Level 3 Assets – Quarterly Change:

(in millions)	Erie Insurance Group						Ending balance at September 30, 2013
	Beginning balance at June 30, 2013	Included in earnings (1)	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3 (2)	
<b>Indemnity</b>							
Available-for-sale securities:							
Corporate debt securities	\$1	\$0	\$ 0	\$ 0	\$0	\$0	\$1
Collateralized debt obligations	1	0	0	0	0	0	1
Total fixed maturities	2	0	0	0	0	0	2
Total available-for-sale securities	2	0	0	0	0	0	2
Other investments	20	0	0	0	(1 )	0	19
Total Level 3 assets – Indemnity	\$22	\$0	\$ 0	\$ 0	\$(1 )	\$0	\$21
<b>Exchange</b>							
Available-for-sale securities:							
Corporate debt securities	\$33	\$0	\$ 0	\$ 0	\$0	\$(7 )	\$26
Commercial mortgage-backed securities	4	0	0	0	0	(4 )	0
Collateralized debt obligations	12	0	0	0	(3 )	0	9
Total fixed maturities	49	0	0	0	(3 )	(11 )	35
Nonredeemable preferred stock	7	0	(3 )	0	(4 )	0	0
Total available-for-sale securities	56	0	(3 )	0	(7 )	(11 )	35
Trading securities:							
Common stock	7	3	0	4	0	0	14
Total trading securities	7	3	0	4	0	0	14
Other investments	113	3	0	0	(16 )	0	100
Total Level 3 assets – Exchange	\$176	\$6	\$(3 )	\$ 4	\$(23 )	\$(11 )	\$149
Total Level 3 assets – Erie Insurance Group	\$198	\$6	\$(3 )	\$ 4	\$(24 )	\$(11 )	\$170

These amounts are reported in the Consolidated Statement of Operations. There is \$3 million included in net (1) realized investment gains (losses) and \$3 million included in equity in earnings of limited partnerships for the three months ended September 30, 2013 on Level 3 securities.

Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for (2) individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

We review the fair value hierarchy classifications each reporting period. Transfers between hierarchy levels may occur due to changes in the available market observable inputs. Transfers in and out of level classifications are reported as having occurred at the beginning of the quarter in which the transfers occurred.

For Indemnity, there were no transfers between Level 1 and Level 2 or between Level 2 and Level 3 for the three months ended September 30, 2013.

For the Exchange, there were no transfers between Level 1 and Level 2 or from Level 2 to Level 3 for the three months ended September 30, 2013. Level 3 to Level 2 transfers totaled \$11 million for two fixed maturity holdings. These transfers out of Level 3 were primarily the result of using observable market data to determine the fair value at September 30, 2013.

Table of Contents

## Level 3 Assets – Year-to-Date Change:

(in millions)	Erie Insurance Group						Transfers in and (out) of Level 3 <sup>(2)</sup>	Ending balance at September 30, 2013
	Beginning balance at December 31, 2012	Included in earnings ( <sup>1</sup> )	Included in other comprehensive income	Purchases	Sales			
<b>Indemnity</b>								
Available-for-sale securities:								
Corporate debt securities	\$1	\$0	\$ 0	\$ 0	\$0	\$0	\$0	\$1
Collateralized debt obligations	3	0	0	0	(2 )	0	0	1
Total fixed maturities	4	0	0	0	(2 )	0	0	2
Total available-for-sale securities	4	0	0	0	(2 )	0	0	2
Other investments	19	1	0	0	(1 )	0	0	19
Total Level 3 assets – Indemnity	\$23	\$1	\$ 0	\$ 0	\$(3 )	\$0	\$0	\$21
<b>Exchange</b>								
Available-for-sale securities:								
Corporate debt securities	\$43	\$0	\$ 0	\$ 1	\$(3 )	\$(15 )		\$26
Commercial mortgage-backed securities	0	0	0	0	(1 )	1		0
Collateralized debt obligations	16	2	0	0	(10 )	1		9
Total fixed maturities	59	2	0	1	(14 )	(13 )		35
Nonredeemable preferred stock	0	2	(1 )	4	(10 )	5		0
Total available-for-sale securities	59	4	(1 )	5	(24 )	(8 )		35
Trading securities:								
Common stock	15	0	0	4	(5 )	0		14
Total trading securities	15	0	0	4	(5 )	0		14
Other investments	109	9	0	0	(18 )	0		100
Total Level 3 assets – Exchange	\$183	\$13	\$ (1 )	\$ 9	\$(47 )	\$(8 )		\$149
Total Level 3 assets – Erie Insurance Group	\$206	\$14	\$ (1 )	\$ 9	\$(50 )	\$(8 )		\$170

These amounts are reported in the Consolidated Statement of Operations. There is \$4 million included in net (1) realized investment gains (losses) and \$10 million included in equity in earnings of limited partnerships for the nine months ended September 30, 2013 on Level 3 securities.

Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for (2) individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

For Indemnity, there were no Level 1 to Level 2 transfers for the nine months ended September 30, 2013. Level 2 to Level 1 transfers totaled \$1 million due to trading activity levels related to one preferred stock holding, and there were no transfers between Levels 2 and 3.

For the Exchange, Level 1 to Level 2 transfers totaled \$6 million and Level 2 to Level 1 transfers totaled \$51 million due to trading activity levels related to one preferred stock holding and five preferred stock holdings, respectively, for the nine months ended September 30, 2013. Level 2 to Level 3 transfers totaled \$39 million for seven fixed maturity holdings and one preferred stock holding, and Level 3 to Level 2 transfers totaled \$47 million for six fixed maturity

holdings. These transfers in and out of Level 3 were primarily the result of using non-binding and binding broker quotes, respectively, to determine the fair value at September 30, 2013.

Table of Contents

## Quantitative and Qualitative Disclosures about Unobservable Inputs

(dollars in millions)	Erie Insurance Group September 30, 2013			Unobservable input	Range	Weighted average
	Fair value	No. of holdings	Valuation techniques			
<b>Indemnity</b>						
Corporate debt securities	\$1	1	Market approach	Non-binding broker quote	112.32	
Collateralized debt obligations	1	2	Income approach	Projected maturity date	Mar 2014 - Jul 2015	
				Repayment at maturity	35 - 100%	70.0%
				Discount rate	7.5 - 15.0%	11.0%
Other investments	\$19	2	See (1) below			
Total Level 3 assets – Indemnity	\$21	5				
<b>Exchange</b>						
Corporate debt securities	26	7	Market approach	Non-binding broker quote	107.40 - 115.50	110.00
				Comparable transaction EBITDA multiples	6.7 - 17.1x	8.0x
				Comparable security yield	6.00%	
Collateralized debt obligations	6	4	Income approach	Projected maturity date	Mar 2014 - Oct 2035	
				Repayment at maturity	35 - 100%	90.0%
				Discount rate	7.0 - 18.0%	9.0%
				Projected LIBOR rate	0.26%	
	3	3	Market approach	Non-binding broker quote	21.00 - 64.00	51.00
Common stock	14	4	Market approach	Comparable transaction EBITDA multiples	6.7 - 17.1x	8.0x
				Discount for lack of marketability	5 - 30%	30%
Other investments	100	4	See (1) below			
Total Level 3 assets – Exchange	\$149	22				
Total Level 3 assets – Erie Insurance Group	\$170	27				

(1) Other investments representing certain limited partnerships are recorded at fair value and are based upon net asset value (NAV) provided by the general partner where the unobservable inputs are not reasonably available to us.



Securities valued using unobservable inputs shown above totaled \$170 million at September 30, 2013. Level 3 assets represent less than 1.4% of the total assets measured at fair value on a recurring basis for the Erie Insurance Group.

Corporate debt securities – The unobservable input used in the fair value measurement of certain corporate debt securities is the likelihood of repayment by the underlying entity when there is no market for trading these securities. When available, we obtain non-binding broker quotes to value such securities.

Collateralized-debt-obligation securities – The unobservable inputs used in the fair value measurement of certain collateralized-debt-obligation securities are the repayment at maturity of underlying collateral available to pay note holders, the projected maturity of the underlying security, an expectation that the London Inter-Bank Offer Rates (“LIBOR”) do not change until maturity and a discount rate appropriate for the security. Significant changes in any of those inputs in isolation would result in a significantly higher or lower fair value measurement. Generally, a change in the assumption used for the performance of the underlying collateral is accompanied by an opposite change in the maturity and a directionally opposite change in the discount rate used to value the security. LIBOR assumptions are independent of collateral performance.

Collateralized-debt-obligation securities and Corporate debt securities – When a non-binding broker quote was the only input available, it was considered unobservable.

Table of Contents

Common stock investments and Corporate debt securities – The unobservable inputs used in the fair value measurement of direct private equity common stock investments and certain corporate debt securities are comparable private transaction earnings before interest, taxes, depreciation and amortization (“EBITDA”) multiples, the average EBITDA multiple for comparable publicly traded companies and the amount of discount applied to the price due to the illiquidity of the securities being valued. Significant changes in any of those inputs in isolation could result in a significantly higher or lower fair value measurement.

Table of Contents

The following table represents our consolidated fair value measurements on a recurring basis by asset class and level of input at December 31, 2012:

(in millions)	Erie Insurance Group December 31, 2012 Fair value measurements using:			
	Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
<b>Indemnity</b>				
Available-for-sale securities:				
States & political subdivisions	\$ 185	\$ 0	\$ 185	\$ 0
Corporate debt securities	261	0	260	1
Commercial mortgage-backed securities	3	0	3	0
Collateralized debt obligations	3	0	0	3
Total fixed maturities	452	0	448	4
Nonredeemable preferred stock	29	4	25	0
Common stock	26	26	0	0
Total available-for-sale securities	507	30	473	4
Other investments <sup>(1)</sup>	19	0	0	19
Total – Indemnity	\$526	\$ 30	\$473	\$ 23
<b>Exchange</b>				
Available-for-sale securities:				
U.S. government & agencies	\$ 191	\$ 0	\$ 191	\$ 0
States & political subdivisions	1,321	0	1,321	0
Foreign government securities	16	0	16	0
Corporate debt securities	5,777	0	5,734	43
Residential mortgage-backed securities	231	0	231	0
Commercial mortgage-backed securities	67	0	67	0
Collateralized debt obligations	49	0	33	16
Other debt securities	55	0	55	0
Total fixed maturities	7,707	0	7,648	59
Nonredeemable preferred stock	631	199	432	0
Common stock	314	314	0	0
Total available-for-sale securities	8,652	513	8,080	59
Trading securities:				
Common stock	2,417	2,402	0	15
Total trading securities	2,417	2,402	0	15
Other investments <sup>(1)</sup>	109	0	0	109
Total – Exchange	\$11,178	\$ 2,915	\$8,080	\$ 183
Total – Erie Insurance Group	\$11,704	\$ 2,945	\$8,553	\$ 206

(1) Other investments measured at fair value represent four real estate funds included on the balance sheet as limited partnership investments that are reported under the fair value option. These investments can never be redeemed with the funds. Instead, distributions are received when liquidation of the underlying assets of the funds occur. It is estimated that the underlying assets will generally be liquidated between 5 and 10 years from the inception of the funds. The fair value of these investments is based on the net asset value (NAV) information provided by the general partner. Fair value is based on our proportionate share of the NAV based on the most recent partners' capital

statements received from the general partners, which is generally one quarter prior to our balance sheet date. These values are then analyzed to determine if they represent the NAV at our balance sheet date, with adjustment being made where appropriate. We consider observable market data and perform a review validating the appropriateness of the NAV at each balance sheet date. It is likely that all of the investments will be redeemed at a future date for an amount different than the NAV of our ownership interest in partners' capital as of December 31, 2012. During the year ended December 31, 2012, Indemnity made contributions totaling \$0.2 million and received distributions totaling \$0.3 million, and the Exchange made contributions totaling \$0.7 million and received distributions totaling \$4.7 million for these investments. As of December 31, 2012, the amount of unfunded commitments related to the investments was \$1.5 million for Indemnity and \$4.5 million for the Exchange.

Table of Contents

## Level 3 Assets – Quarterly Change:

(in millions)	Erie Insurance Group						Ending balance at September 30, 2012
	Beginning balance at June 30, 2012	Included in earnings <sup>(1)</sup>	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3 <sup>(2)</sup>	
<b>Indemnity</b>							
Available-for-sale securities:							
Corporate debt securities	\$1	\$0	\$0	\$0	\$0	\$0	\$1
Collateralized debt obligations	4	0	0	0	(1 )	0	3
Total fixed maturities	5	0	0	0	(1 )	0	4
Total available-for-sale securities	5	0	0	0	(1 )	0	4
Other investments <sup>(3)</sup>	18	0	0	0	0	0	18
Total Level 3 assets – Indemnity	\$23	\$0	\$0	\$0	\$(1 )	\$0	\$22
<b>Exchange</b>							
Available-for-sale securities:							
States & political subdivisions	\$4	\$0	\$0	\$0	\$0	\$0	\$4
Corporate debt securities	23	0	1	0	0	10	34
Collateralized debt obligations	27	0	0	0	(4 )	23	46
Other debt securities	5	0	0	0	0	0	5
Total fixed maturities	59	0	1	0	(4 )	33	89
Nonredeemable preferred stock	5	0	1	0	0	0	6
Total available-for-sale securities	64	0	2	0	(4 )	33	95
Trading securities:							
Common stock	14	(1 )	0	0	0	0	13
Total trading securities	14	(1 )	0	0	0	0	13
Other investments <sup>(3)</sup>	107	3	0	0	(2 )	0	108
Total Level 3 assets – Exchange	\$185	\$2	\$2	\$0	\$(6 )	\$33	\$216
Total Level 3 assets – Erie Insurance Group	\$208	\$2	\$2	\$0	\$(7 )	\$33	\$238

These amounts are reported in the Consolidated Statement of Operations. There is \$(1) million included in net (1) realized investment gains (losses) and \$3 million included in equity in earnings of limited partnerships for the three months ended September 30, 2012 on Level 3 securities.

Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for (2) individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

The other investments reported as Level 3 assets represent real estate funds which were previously presented with (3) our limited partnerships reported under the equity method of accounting and therefore were not included in our fair value measurements table. This table has been adjusted to reflect the appropriate fair value of these assets for the three months ended September 30, 2012.

We review the fair value hierarchy classifications each reporting period. Transfers between hierarchy levels may occur due to changes in the available market observable inputs. Transfers in and out of level classifications are reported as having occurred at the beginning of the quarter in which the transfers occurred.

For Indemnity, Level 1 to Level 2 transfers totaled \$2 million and Level 2 to Level 1 transfers totaled \$1 million due to trading activity levels related to one preferred stock holding and one preferred stock holding, respectively, for the three months ended September 30, 2012. There were no transfers between Level 2 and Level 3.

For the Exchange, Level 1 to Level 2 transfers totaled \$42 million and Level 2 to Level 1 transfers totaled \$35 million due to trading activity levels related to three preferred stock holdings and five preferred stock holdings, respectively, for the three months ended September 30, 2012. Transfers between Level 2 and Level 3 totaled \$34 million and Level 3 to Level 2 transfers totaled \$1 million related to four fixed maturity holdings and one fixed maturity holding, respectively. These transfers in and out of Level 3 were primarily the result of using unobservable and observable market data, respectively, to determine the fair value at September 30, 2012.

Table of Contents

## Level 3 Assets – Year-to-Date Change:

(in millions)	Erie Insurance Group						Ending balance at September 30, 2012
	Beginning balance at December 31, 2011	Included in earnings <sup>(1)</sup>	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3 <sup>(2)</sup>	
<b>Indemnity</b>							
Corporate debt securities	\$0	\$0	\$0	\$0	\$0	\$1	\$1
Collateralized debt obligations	4	0	0	0	(1 )	0	3
Total fixed maturities	4	0	0	0	(1 )	1	4
Total available-for-sale securities	4	0	0	0	(1 )	1	4
Other investments <sup>(3)</sup>	17	1	0	0	0	0	18
Total Level 3 assets – Indemnity	\$21	\$1	\$0	\$0	\$(1 )	\$1	\$22
<b>Exchange</b>							
Available-for-sale securities:							
States & political subdivisions	\$4	\$0	\$0	\$0	\$0	\$0	\$4
Corporate debt securities	12	0	1	1	(5 )	25	34
Collateralized debt obligations	29	1	3	0	(7 )	20	46
Other debt securities	5	0	0	0	0	0	5
Total fixed maturities	50	1	4	1	(12 )	45	89
Nonredeemable preferred stock	5	0	1	0	0	0	6
Total available-for-sale securities	55	1	5	1	(12 )	45	95
Trading securities:							
Common stock	12	2	0	0	(1 )	0	13
Total trading securities	12	2	0	0	(1 )	0	13
Other investments <sup>(3)</sup>	102	9	0	0	(3 )	0	108
Total Level 3 assets – Exchange	\$169	\$12	\$5	\$1	\$(16 )	\$45	\$216
Total Level 3 assets – Erie Insurance Group	\$190	\$13	\$5	\$1	\$(17 )	\$46	\$238

These amounts are reported in the Consolidated Statement of Operations. There is \$3 million included in net (1) realized investment gains (losses) and \$10 million included in equity in earnings of limited partnerships for the nine months ended September 30, 2012 on Level 3 securities.

Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for (2) individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

The other investments reported as Level 3 assets represent real estate funds which were previously presented with (3) our limited partnerships reported under the equity method of accounting and therefore were not included in our fair value measurements table. This table has been adjusted to reflect the appropriate fair value of these assets for the nine months ended September 30, 2012.

For Indemnity, Level 1 to Level 2 transfers totaled \$3 million and Level 2 to Level 1 transfers totaled \$1 million due to trading activity levels related to two preferred stock holdings and one preferred stock holding, respectively, for the nine months ended September 30, 2012. Level 2 to Level 3 transfers totaled \$1 million due to trading activity levels related to one fixed maturity holding, and there were no transfers from Level 3 to Level 2.

For the Exchange, Level 1 to Level 2 transfers totaled \$56 million and Level 2 to Level 1 transfers totaled \$53 million due to trading activity levels related to six preferred stock holdings and six preferred stock holdings, respectively, for the nine months ended September 30, 2012. Level 2 to Level 3 transfers totaled \$46 million and Level 3 to Level 2 transfers totaled \$1 million related to eight fixed maturity holdings and one fixed maturity holding, respectively. These transfers in and out of Level 3 were primarily the result of using non-binding and binding broker quotes, respectively, to determine the fair value at September 30, 2012.



Table of Contents

The following table sets forth our consolidated fair value measurements on a recurring basis by pricing source at September 30, 2013:

(in millions)	Erie Insurance Group September 30, 2013			
	Total	Level 1	Level 2	Level 3
<b>Indemnity</b>				
Fixed maturities:				
Priced via pricing services	\$497	\$0	\$497	\$0
Priced via market comparables/broker quotes <sup>(1)</sup>	1	0	0	1
Priced via internal modeling	1	0	0	1
Total fixed maturities	499	0	497	2
Nonredeemable preferred stock:				
Priced via pricing services	21	2	19	0
Priced via market comparables/broker quotes <sup>(1)</sup>	2	0	2	0
Priced via internal modeling	0	0	0	0
Total nonredeemable preferred stock	23	2	21	0
Common stock:				
Priced via pricing services	25	25	0	0
Priced via market comparables/broker quotes <sup>(1)</sup>	0	0	0	0
Priced via internal modeling	0	0	0	0
Total common stock	25	25	0	0
Other investments:				
Priced via unobservable inputs <sup>(2)</sup>	19	0	0	19
Total other investments	19	0	0	19
Total – Indemnity	\$566	\$27	\$518	\$21
<b>Exchange</b>				
Fixed maturities:				
Priced via pricing services	\$7,836	\$0	\$7,836	\$0
Priced via market comparables/broker quotes <sup>(1)</sup>	71	0	50	21
Priced via internal modeling	14	0	0	14
Total fixed maturities	7,921	0	7,886	35
Nonredeemable preferred stock:				
Priced via pricing services	597	230	367	0
Priced via market comparables/broker quotes <sup>(1)</sup>	14	0	14	0
Priced via internal modeling	0	0	0	0
Total nonredeemable preferred stock	611	230	381	0
Common stock:				
Priced via pricing services	3,169	3,169	0	0
Priced via market comparables/broker quotes <sup>(1)</sup>	0	0	0	0
Priced via internal modeling	14	0	0	14
Total common stock	3,183	3,169	0	14
Other investments:				
Priced via unobservable inputs <sup>(2)</sup>	100	0	0	100
Total other investments	100	0	0	100
Total – Exchange	\$11,815	\$3,399	\$8,267	\$149
Total – Erie Insurance Group	\$12,381	\$3,426	\$8,785	\$170

(1) When a non-binding broker quote was the only price available, the security was classified as Level 3.

Other investments measured at fair value represent real estate funds included on the balance sheet as limited (2) partnership investments that are reported under the fair value option. The fair value of these investments is based on the net asset value (NAV) information provided by the general partner.

There were no assets measured at fair value on a nonrecurring basis during the nine months ended September 30, 2013.

Table of Contents

## Note 7. Investments

## Available-for-sale securities

The following table summarizes the cost and fair value of our available-for-sale securities at September 30, 2013:

(in millions)	Erie Insurance Group September 30, 2013			Estimated fair value
	Amortized cost	Gross unrealized gains	Gross unrealized losses	
Indemnity				
Available-for-sale securities:				
States & political subdivisions	\$212	\$ 8	\$ 1	\$219
Corporate debt securities	278	2	1	279
Collateralized debt obligations	1	0	0	1
Total fixed maturities	491	10	2	499
Nonredeemable preferred stock	22	1	0	23
Common stock	26	0	1	25
Total available-for-sale securities – Indemnity	\$539	\$ 11	\$ 3	\$547
Exchange				
Available-for-sale securities:				
U.S. government & agencies	\$173	\$ 2	\$ 2	\$173
States & political subdivisions	1,383	60	12	1,431
Foreign government securities	15	0	0	15
Corporate debt securities	5,647	367	45	5,969
Residential mortgage-backed securities	200	4	5	199
Commercial mortgage-backed securities	46	2	0	48
Collateralized debt obligations	13	7	0	20
Other debt securities	64	3	1	66
Total fixed maturities	7,541	445	65	7,921
Nonredeemable preferred stock	568	53	10	611
Common stock	241	0	3	238
Total available-for-sale securities – Exchange	\$8,350	\$ 498	\$ 78	\$8,770
Total available-for-sale securities – Erie Insurance Group	\$8,889	\$ 509	\$ 81	\$9,317

Table of Contents

The following table summarizes the cost and fair value of our available-for-sale securities at December 31, 2012:

(in millions)	Erie Insurance Group December 31, 2012			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
<b>Indemnity</b>				
Available-for-sale securities:				
States & political subdivisions	\$ 172	\$ 13	\$ 0	\$ 185
Corporate debt securities	259	2	0	261
Commercial mortgage-backed securities	3	0	0	3
Collateralized debt obligations	3	0	0	3
Total fixed maturities	437	15	0	452
Nonredeemable preferred stock	28	2	1	29
Common stock	26	0	0	26
Total available-for-sale securities – Indemnity	\$491	\$ 17	\$ 1	\$507
<b>Exchange</b>				
Available-for-sale securities:				
U.S. government & agencies	\$ 190	\$ 2	\$ 1	\$ 191
States & political subdivisions	1,218	103	0	1,321
Foreign government securities	15	1	0	16
Corporate debt securities	5,211	569	3	5,777
Residential mortgage-backed securities	226	6	1	231
Commercial mortgage-backed securities	62	5	0	67
Collateralized debt obligations	43	6	0	49
Other debt securities	51	4	0	55
Total fixed maturities	7,016	696	5	7,707
Nonredeemable preferred stock	555	77	1	631
Common stock	316	0	2	314
Total available-for-sale securities – Exchange	\$7,887	\$ 773	\$ 8	\$8,652
Total available-for-sale securities – Erie Insurance Group	\$8,378	\$ 790	\$ 9	\$9,159

The amortized cost and estimated fair value of fixed maturities at September 30, 2013 are shown below by remaining contractual term to maturity. Mortgage-backed securities are allocated based upon their stated maturity dates.

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(in millions)	Erie Insurance Group September 30, 2013	
	Amortized cost	Estimated fair value
<b>Indemnity</b>		
Due in one year or less	\$ 106	\$ 106
Due after one year through five years	239	242
Due after five years through ten years	71	73
Due after ten years	75	78
Total fixed maturities – Indemnity	\$491	\$499

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Exchange		
Due in one year or less	476	484
Due after one year through five years	2,681	2,862
Due after five years through ten years	2,781	2,927
Due after ten years	1,603	1,648
Total fixed maturities – Exchange	\$7,541	\$7,921
Total fixed maturities – Erie Insurance Group	\$8,032	\$8,420

25

---

Table of Contents

Available-for-sale securities in a gross unrealized loss position at September 30, 2013 are as follows. Data is provided by length of time for securities in a gross unrealized loss position.

(dollars in millions)	Erie Insurance Group September 30, 2013						No. of holdings
	Less than 12 months Fair value	Unrealized losses	12 months or longer Fair value	Unrealized losses	Total Fair value	Unrealized losses	
Indemnity							
Available-for-sale securities:							
States & political subdivisions	\$23	\$1	\$0	\$0	\$23	\$1	10
Corporate debt securities	73	1	10	0	83	1	15
Total fixed maturities	96	2	10	0	106	2	25
Nonredeemable preferred stock	3	0	6	0	9	0	4
Common stock	25	1	0	0	25	1	2
Total available-for-sale securities – Indemnity	\$124	\$3	\$16	\$0	\$140	\$3	31
Quality breakdown of fixed maturities:							
Investment grade	\$96	\$2	\$10	\$0	\$106	\$2	25
Non-investment grade	0	0	0	0	0	0	0
Total fixed maturities – Indemnity	\$96	\$2	\$10	\$0	\$106	\$2	25
Exchange							
Available-for-sale securities:							
U.S. government & agencies	\$104	\$2	\$0	\$0	\$104	\$2	7
States & political subdivisions	309	12	0	0	309	12	77
Foreign government securities	5	0	0	0	5	0	1
Corporate debt securities	1,116	44	6	1	1,122	45	199
Residential mortgage-backed securities	87	4	14	1	101	5	18
Other debt securities	32	1	0	0	32	1	6
Total fixed maturities	1,653	63	20	2	1,673	65	308
Nonredeemable preferred stock	165	9	15	1	180	10	24
Common stock	238	3	0	0	238	3	3
Total available-for-sale securities – Exchange	\$2,056	\$75	\$35	\$3	\$2,091	\$78	335
Quality breakdown of fixed maturities:							
Investment grade	\$1,561	\$58	\$19	\$2	\$1,580	\$60	289
Non-investment grade	92	5	1	0	93	5	19
Total fixed maturities – Exchange	\$1,653	\$63	\$20	\$2	\$1,673	\$65	308

The above securities for Indemnity and the Exchange have been evaluated and determined to be temporary impairments for which we expect to recover our entire principal plus interest. The primary components of this analysis include a general review of market conditions and financial performance of the issuer along with the extent and duration at which fair value is less than cost. Any securities that we intend to sell or will more likely than not be required to sell before recovery are included in other-than-temporary impairments with the impairment charges recognized in earnings.

Table of Contents

Available-for-sale securities in a gross unrealized loss position at December 31, 2012 are as follows. Data is provided by length of time for securities in a gross unrealized loss position.

(dollars in millions)	Erie Insurance Group						
	December 31, 2012						
	Less than 12 months		12 months or longer		Total		No. of holdings
Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses		
Indemnity							
Available-for-sale securities:							
Corporate debt securities	\$59	\$0	\$0	\$0	\$59	\$0	12
Commercial mortgage-backed securities	0	0	3	0	3	0	1
Total fixed maturities	59	0	3	0	62	0	13
Nonredeemable preferred stock	7	0	3	1	10	1	4
Common stock	26	0	0	0	26	0	2
Total available-for-sale securities – Indemnity	\$92	\$0	\$6	\$1	\$98	\$1	19
Quality breakdown of fixed maturities:							
Investment grade	\$55	\$0	\$3	\$0	\$58	\$0	12
Non-investment grade	4	0	0	0	4	0	1
Total fixed maturities – Indemnity	\$59	\$0	\$3	\$0	\$62	\$0	13
Exchange							
Available-for-sale securities:							
U.S. government & agencies	\$80	\$1	\$0	\$0	\$80	\$1	7
States & political subdivisions	23	0	0	0	23	0	11
Corporate debt securities	152	3	9	0	161	3	31
Residential mortgage-backed securities	56	1	0	0	56	1	9
Collateralized debt obligations	0	0	21	0	21	0	1
Other debt securities	5	0	0	0	5	0	2
Total fixed maturities	316	5	30	0	346	5	61
Nonredeemable preferred stock	64	0	18	1	82	1	13
Common stock	314	2	0	0	314	2	3
Total available-for-sale securities – Exchange	\$694	\$7	\$48	\$1	\$742	\$8	77
Quality breakdown of fixed maturities:							
Investment grade	\$296	\$4	\$24	\$0	\$320	\$4	53
Non-investment grade	20	1	6	0	26	1	8
Total fixed maturities – Exchange	\$316	\$5	\$30	\$0	\$346	\$5	61

The above securities for Indemnity and the Exchange have been evaluated and determined to be temporary impairments for which we expect to recover our entire principal plus interest. The primary components of this analysis include a general review of market conditions and financial performance of the issuer along with the extent and duration at which fair value is less than cost. Any securities that we intend to sell or will more likely than not be required to sell before recovery are included in other-than-temporary impairments with the impairment charges recognized in earnings.

Table of Contents

## Net investment income

Interest and dividend income are recognized as earned and recorded to net investment income. Investment income, net of expenses, was generated from the following portfolios:

(in millions)	Erie Insurance Group		Nine months ended September	
	Three months ended September 30,		30,	2012
	2013	2012	2013	2012
Indemnity				
Fixed maturities	\$3	\$4	\$9	\$10
Equity securities	1	0	2	2
Cash equivalents and other	0	1	1	1
Total investment income	4	5	12	13
Less: investment expenses	0	1	1	1
Investment income, net of expenses – Indemnity	\$4	\$4	\$11	\$12
Exchange				
Fixed maturities	\$83	\$87	\$249	\$266
Equity securities	29	23	80	72
Cash equivalents and other	1	0	1	2
Total investment income	113	110	330	340
Less: investment expenses	8	9	25	26
Investment income, net of expenses – Exchange	\$105	\$101	\$305	\$314
Investment income, net of expenses – Erie Insurance Group	\$109	\$105	\$316	\$326



Table of Contents

## Realized investment gains (losses)

Realized gains and losses on sales of securities are recognized in income based upon the specific identification method. Realized gains (losses) on investments were as follows:

(in millions)	Erie Insurance Group		Nine months ended September	
	Three months ended September 30, 2013	2012	30, 2013	2012
Indemnity				
Available-for-sale securities:				
Fixed maturities:				
Gross realized gains	\$1	\$0	\$1	\$0
Gross realized losses	0	0	0	0
Net realized gains	1	0	1	0
Equity securities:				
Gross realized gains	0	0	0	0
Gross realized losses	0	0	0	0
Net realized gains	0	0	0	0
Trading securities:				
Common stock:				
Gross realized gains	0	0	0	1
Gross realized losses	0	0	0	0
Increases in fair value <sup>(1)</sup>	0	2	0	3
Net realized gains	0	2	0	4
Net realized investment gains – Indemnity	\$1	\$2	\$1	\$4
Exchange				
Available-for-sale securities:				
Fixed maturities:				
Gross realized gains	\$4	\$22	\$26	\$47
Gross realized losses	(20 )	(6 )	(25 )	(12 )
Net realized (losses) gains	(16 )	16	1	35
Equity securities:				
Gross realized gains	0	5	4	10
Gross realized losses	(9 )	(5 )	(9 )	(7 )
Net realized (losses) gains	(9 )	0	(5 )	3
Trading securities:				
Common stock:				
Gross realized gains	90	37	246	122
Gross realized losses	(8 )	(24 )	(23 )	(57 )
Increases in fair value <sup>(1)</sup>	133	138	281	251
Net realized gains	215	151	504	316
Net realized investment gains – Exchange	\$190	\$167	\$500	\$354
Net realized investment gains – Erie Insurance Group	\$191	\$169	\$501	\$358

(1) The fair value on our common stock portfolio is based upon exchange traded prices provided by a nationally recognized pricing service.



Table of Contents

## Net impairment losses

The components of other-than-temporary impairments on investments are included below:

(in millions)	Erie Insurance Group		Nine months ended	
	Three months ended September 30,		September 30,	
	2013	2012	2013	2012
Indemnity				
Fixed maturities	\$0	\$0	\$0	\$0
Equity securities	0	0	0	0
Total other-than-temporary impairments	0	0	0	0
Portion recognized in other comprehensive income	0	0	0	0
Net impairment losses recognized in earnings – Indemnity	\$0	\$0	\$0	\$0
Exchange				
Fixed maturities	\$1	\$0	\$2	\$0
Equity securities	8	0	8	0
Total other-than-temporary impairments	9	0	10	0
Portion recognized in other comprehensive income	0	0	0	0
Net impairment losses recognized in earnings – Exchange	\$9	\$0	\$10	\$0
Net impairment losses recognized in earnings – Erie Insurance Group	\$9	\$0	\$10	\$0

In considering if fixed maturity securities were credit-impaired, some of the factors considered include: potential for the default of interest and/or principal, level of subordination, collateral of the issue, compliance with financial covenants, credit ratings and industry conditions. We have the intent to sell all credit-impaired fixed maturity securities, therefore the entire amount of the impairment charges were included in earnings and no non-credit impairments were recognized in other comprehensive income.

## Limited partnerships

Limited partnership investments, excluding certain real estate limited partnerships recorded at fair value, are generally reported on a one-quarter lag, therefore our year-to-date limited partnership results through September 30, 2013 are comprised of partnership financial results for the fourth quarter of 2012 and first six months of 2013. Given the lag in reporting, our limited partnership results do not reflect the market conditions of the third quarter of 2013. Cash contributions made to and distributions received from the partnerships are recorded in the period in which the transaction occurs.

We have provided summarized financial information in the following table for the nine months ended September 30, 2013 and for the year ended December 31, 2012. Amounts provided in the table are presented using the latest available financial statements received from the partnerships. Limited partnership financial information has been presented based upon the investment percentage in the partnerships for the Erie Insurance Group consistent with how management evaluates the investments.

Table of Contents

As these investments are generally reported on a one-quarter lag, our limited partnership results through September 30, 2013 include partnership financial results for the fourth quarter of 2012 and the first two quarters of 2013.

(dollars in millions)	Erie Insurance Group			
	As of and for the nine months ended September 30, 2013			
Investment percentage in limited partnerships	Number of partnerships	Asset recorded	Income (loss) recognized due to valuation adjustments by the partnerships	Income (loss) recorded
<b>Indemnity</b>				
<b>Private equity:</b>				
Less than 10%	26	\$51	\$(7 )	\$7
Greater than or equal to 10% but less than 50%	3	14	2	0
Greater than 50%	0	0	0	0
<b>Total private equity</b>	<b>29</b>	<b>65</b>	<b>(5 )</b>	<b>7</b>
<b>Mezzanine debt:</b>				
Less than 10%	11	15	0	1
Greater than or equal to 10% but less than 50%	3	7	0	2
Greater than 50%	1	0	0	0
<b>Total mezzanine debt</b>	<b>15</b>	<b>22</b>	<b>0</b>	<b>3</b>
<b>Real estate:</b>				
Less than 10%	12	47	1	3
Greater than or equal to 10% but less than 50%	3	15	1	2
Greater than 50%	3	9	1	0
<b>Total real estate</b>	<b>18</b>	<b>71</b>	<b>3</b>	<b>5</b>
<b>Total limited partnerships – Indemnity</b>	<b>62</b>	<b>\$158</b>	<b>\$(2 )</b>	<b>\$15</b>
<b>Exchange</b>				
<b>Private equity:</b>				
Less than 10%	43	\$414	\$(29 )	\$65
Greater than or equal to 10% but less than 50%	3	63	11	(1 )
Greater than 50%	0	0	0	0
<b>Total private equity</b>	<b>46</b>	<b>477</b>	<b>(18 )</b>	<b>64</b>
<b>Mezzanine debt:</b>				
Less than 10%	19	121	1	11
Greater than or equal to 10% but less than 50%	4	23	(1 )	5
Greater than 50%	3	34	1	2
<b>Total mezzanine debt</b>	<b>26</b>	<b>178</b>	<b>1</b>	<b>18</b>
<b>Real estate:</b>				
Less than 10%	22	216	(5 )	24
Greater than or equal to 10% but less than 50%	6	76	2	7
Greater than 50%	3	32	(2 )	8
<b>Total real estate</b>	<b>31</b>	<b>324</b>	<b>(5 )</b>	<b>39</b>
<b>Total limited partnerships – Exchange</b>	<b>103</b>	<b>\$979</b>	<b>\$(22 )</b>	<b>\$121</b>
<b>Total limited partnerships – Erie Insurance Group</b>		<b>\$1,137</b>	<b>\$(24 )</b>	<b>\$136</b>

Per the limited partnership financial statements, total partnership assets were \$49 billion and total partnership liabilities were \$5 billion at September 30, 2013 (as recorded in the June 30, 2013 limited partnership financial statements). For the nine months period comparable to that presented in the preceding table (fourth quarter of 2012 and first two quarters of 2013), total partnership valuation adjustment gains were \$1 billion and total partnership net income was \$5 billion.

Table of Contents

As these investments are generally reported on a one-quarter lag, our limited partnership results through December 31, 2012 include partnership financial results for the fourth quarter of 2011 and the first three quarters of 2012.

(dollars in millions)	Erie Insurance Group			
	As of and for the year ended December 31, 2012			
Investment percentage in limited partnerships	Number of partnerships	Asset recorded	Income (loss) recognized due to valuation adjustments by the partnerships	Income (loss) recorded
<b>Indemnity</b>				
<b>Private equity:</b>				
Less than 10%	26	\$60	\$(3 )	\$6
Greater than or equal to 10% but less than 50%	3	13	4	0
Greater than 50%	0	0	0	0
<b>Total private equity</b>	<b>29</b>	<b>73</b>	<b>1</b>	<b>6</b>
<b>Mezzanine debt:</b>				
Less than 10%	11	18	(2 )	5
Greater than or equal to 10% but less than 50%	3	9	0	2
Greater than 50%	1	0	1	(1 )
<b>Total mezzanine debt</b>	<b>15</b>	<b>27</b>	<b>(1 )</b>	<b>6</b>
<b>Real estate:</b>				
Less than 10%	12	55	4	(3 )
Greater than or equal to 10% but less than 50%	3	16	(1 )	1
Greater than 50%	3	9	2	0
<b>Total real estate</b>	<b>18</b>	<b>80</b>	<b>5</b>	<b>(2 )</b>
<b>Total limited partnerships – Indemnity</b>	<b>62</b>	<b>\$180</b>	<b>\$5</b>	<b>\$10</b>
<b>Exchange</b>				
<b>Private equity:</b>				
Less than 10%	42	\$424	\$22	\$24
Greater than or equal to 10% but less than 50%	3	58	16	(1 )
Greater than 50%	0	0	0	0
<b>Total private equity</b>	<b>45</b>	<b>482</b>	<b>38</b>	<b>23</b>
<b>Mezzanine debt:</b>				
Less than 10%	18	132	(5 )	29
Greater than or equal to 10% but less than 50%	4	27	1	4
Greater than 50%	3	37	(2 )	5
<b>Total mezzanine debt</b>	<b>25</b>	<b>196</b>	<b>(6 )</b>	<b>38</b>
<b>Real estate:</b>				
Less than 10%	22	274	(7 )	26
Greater than or equal to 10% but less than 50%	5	52	(4 )	3
Greater than 50%	3	33	6	(1 )
<b>Total real estate</b>	<b>30</b>	<b>359</b>	<b>(5 )</b>	<b>28</b>
<b>Total limited partnerships – Exchange</b>	<b>100</b>	<b>\$1,037</b>	<b>\$27</b>	<b>\$89</b>
<b>Total limited partnerships – Erie Insurance Group</b>		<b>\$1,217</b>	<b>\$32</b>	<b>\$99</b>

Per the limited partnership financial statements, total partnership assets were \$53 billion and total partnership liabilities were \$6 billion at December 31, 2012 (as recorded in the September 30, 2012 limited partnership financial statements). For the twelve month period comparable to that presented in the preceding table (fourth quarter of 2011 and first three quarters of 2012), total partnership valuation adjustment gains were \$2 billion and total partnership net income was \$5 billion.

See also Note 14. "Commitments and Contingencies," for investment commitments related to limited partnerships.

Table of Contents

Note 8. Bank Line of Credit

As of September 30, 2013, Indemnity has access to a \$100 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on November 3, 2016. As of September 30, 2013, a total of \$98.2 million remains available under the facility due to \$1.8 million outstanding letters of credit, which reduce the availability for letters of credit to \$23.2 million. There were no borrowings outstanding on the line of credit as of September 30, 2013. Bonds with a fair value of \$111 million were pledged as collateral on the line at September 30, 2013.

As of September 30, 2013, the Exchange has access to a \$300 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on October 28, 2016. As of September 30, 2013, a total of \$298.9 million remains available under the facility due to \$1.1 million outstanding letters of credit, which reduce the availability for letters of credit to \$23.9 million. There were no borrowings outstanding on the line of credit as of September 30, 2013. Bonds with a fair value of \$332 million were pledged as collateral on the line at September 30, 2013.

Both lines have securities pledged as collateral that have no trading restrictions and are reported as available-for-sale fixed maturities in the Consolidated Statements of Financial Position as of September 30, 2013. The banks require compliance with certain covenants, which include minimum net worth and leverage ratios for Indemnity's line of credit and statutory surplus and risk based capital ratios for the Exchange's line of credit. We are in compliance with all covenants at September 30, 2013.

On October 25, 2013, Indemnity amended its revolving credit facility to extend the maturity date to November 3, 2018, lower the borrowing costs, and eliminate the minimum net worth financial covenant.

On October 25, 2013, the Exchange entered into a second amended and restated credit agreement to extend the maturity date to October 25, 2018, lower the borrowing costs, and eliminate the minimum statutory surplus covenant.

Note 9. Income Taxes

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the financial statements or tax returns. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

At September 30, 2013, we recorded a net deferred tax liability of \$326 million on our Consolidated Statements of Financial Position. Of this amount, \$42 million is a net deferred tax asset attributable to Indemnity and \$368 million is a net deferred tax liability attributable to the Exchange. There was no deferred tax valuation allowance recorded at September 30, 2013. Our effective tax rate is calculated after consideration of permanent differences related to our investment revenues. Given that these amounts represent over 98% of the total permanent differences, the effective tax rate is approximately 35% for both Indemnity and the Exchange when the investment related permanent differences are excluded.



Table of Contents

## Note 10. Postretirement Benefits

The liabilities for the postretirement plans described in this note are presented in total for all employees of the Erie Insurance Group. The gross liability for postretirement benefits is presented in the Consolidated Statements of Financial Position as part of other liabilities. A portion of annual expenses related to our postretirement benefit plans is allocated to related entities within the Erie Insurance Group.

We offer a noncontributory defined benefit pension plan that covers substantially all employees. This is the largest postretirement benefit plan we offer. We also offer an unfunded supplemental employee retirement plan ("SERP") for certain members of executive and senior management of the Erie Insurance Group. The cost of our pension plans are as follows:

(in millions)	Erie Insurance Group			
	Three months ended September 30, 2013		Nine months ended September 30, 2013	
	2013	2012	2013	2012
Service cost for benefits earned	\$7	\$5	\$20	\$16
Interest cost on benefits obligation	6	6	19	18
Expected return on plan assets	(8	) (6	) (23	) (20
Prior service cost amortization	0	1	1	1
Net actuarial loss amortization	4	2	11	8
Pension plan cost	\$9	\$8	\$28	\$23

Prior to 2003, the employee pension plan purchased annuities from EFL for certain plan participants that were receiving benefit payments under the pension plan. These are nonparticipating annuity contracts under which EFL has unconditionally contracted to provide specified benefits to beneficiaries; however, the pension plan remains the primary obligor to the beneficiaries and a contingent liability, \$27 million at September 30, 2013, exists in the event EFL does not honor the annuity contracts.

## Note 11. Indemnity Capital Stock

## Class A and B common stock

Holders of Class B shares may, at their option, convert their shares into Class A shares at the rate of 2,400 Class A shares per Class B share. There were no share conversions during the nine months ended September 30, 2013. In both the first and fourth quarters of 2012, two shares of Class B common stock were converted into 4,800 shares of Class A common stock. There is no provision for conversion of Class A shares to Class B shares, and, Class B shares surrendered for conversion cannot be reissued.

## Stock repurchase program

In October 2011, our Board of Directors approved a continuation of the current stock repurchase program for a total of \$150 million, with no time limitation. Indemnity had approximately \$47 million of repurchase authority remaining under this program at September 30, 2013.

Table of Contents

## Note 12. Indemnity Accumulated Other Comprehensive Loss

Changes in Indemnity's accumulated other comprehensive loss by component attributable to the Indemnity shareholder interest is presented as follows for the nine months ended September 30, 2013:

(in millions)	Indemnity Shareholder Interest		
	Unrealized holding gains (losses) on available-for-sale securities	Postretirement plans <sup>(2)</sup>	Total
Balance at December 31, 2012	\$13	\$(146)	\$(133)
Other comprehensive loss before reclassifications, net of tax	(8)	0	(8)
Amounts reclassified from accumulated other comprehensive loss, net of tax <sup>(1)</sup>	1	0	1
Net current period other comprehensive loss, net of tax	(7)	0	(7)
Balance at September 30, 2013	\$6	\$(146)	\$(140)

(1) See the following table for details about these reclassifications.

(2) There are no amounts reclassified out of accumulated other comprehensive loss related to postretirement plan items during interim periods.

Amounts reclassified out of accumulated other comprehensive income (loss) and the related affected line item in the Consolidated Statements of Operations where net income is presented are as follows for the three and nine months ended September 30, 2013:

(in millions)	Erie Insurance Group	
	Three months ended September 30, 2013	Nine months ended September 30, 2013
Amounts reclassified from accumulated other comprehensive income (loss) <sup>(1)</sup>		
Unrealized holding gains (losses) on available-for-sale securities:		
Net realized investment losses	\$(24)	\$(3)
Net impairment losses recognized in earnings	(9)	(10)
Loss from operations before income taxes and noncontrolling interest	(33)	(13)
Provision for income taxes	(12)	(5)
Net loss	(21)	(8)
Less: Net loss attributable to noncontrolling interest in consolidated entity – Exchange	(22)	(9)
Net income attributable to Indemnity	\$1	\$1
Amortization of postretirement plan items <sup>(2)</sup> :		
Net income attributable to Indemnity	\$0	\$0
Net income attributable to Indemnity	\$1	\$1

(1) Positive amounts indicate net income, while negative amounts indicate net loss.

(2)

There are no amounts reclassified out of accumulated other comprehensive loss related to postretirement plan items during interim periods.

Table of Contents

## Note 13. Indemnity Shareholders' Equity and Noncontrolling Interest

A reconciliation of the beginning and ending balances of Indemnity's shareholders' equity and the noncontrolling interest is presented as follows for the year ended December 31, 2012 and for the nine months ended September 30, 2013:

(in millions, except per share data)	Erie Insurance Group		
	Indemnity shareholder interest	Exchange noncontrolling interest	Erie Insurance Group
Balance at December 31, 2011	\$781	\$5,512	\$6,293
Net income	160	459	619
Change in other comprehensive (loss) income, net of tax	(28	) 178	150
Net purchase of treasury stock	(69	) —	(69
Dividends declared:			
Class A \$4.25 per share	(200	) —	(200
Class B \$637.50 per share	(2	) —	(2
Balance at December 31, 2012	\$642	\$6,149	\$6,791
Net income	127	607	734
Change in other comprehensive loss, net of tax	(7	) (214	) (221
Net purchase of treasury stock	(22	) —	(22
Dividends declared:			
Class A \$1.7775 per share	(82	) —	(82
Class B \$266.6250 per share	(1	) —	(1
Balance at September 30, 2013	\$657	\$6,542	\$7,199

## Note 14. Commitments and Contingencies

Indemnity has contractual commitments to invest up to \$30 million related to its limited partnership investments at September 30, 2013. These commitments are split among private equity securities of \$14 million, mezzanine debt securities of \$10 million, and real estate activities of \$6 million. These commitments will be funded as required by the partnership agreements.

The Exchange, including EFL, has contractual commitments to invest up to \$388 million related to its limited partnership investments at September 30, 2013. These commitments are split among private equity securities of \$137 million, mezzanine debt securities of \$164 million, and real estate activities of \$87 million. These commitments will be funded as required by the partnership agreements.

We are involved in litigation arising in the ordinary course of conducting business. In accordance with current accounting standards for loss contingencies and based upon information currently known to us, we establish reserves for litigation when it is probable that a loss associated with a claim or proceeding has been incurred and the amount of the loss or range of loss can be reasonably estimated. When no amount within the range of loss is a better estimate than any other amount, we accrue the minimum amount of the estimable loss. To the extent that such litigation against us may have an exposure to a loss in excess of the amount we have accrued, we believe that such excess would not be material to our consolidated financial condition, results of operations or cash flows. Legal fees are expensed as incurred. We believe that our accruals for legal proceedings are appropriate and, individually and in the aggregate, are not expected to be material to our consolidated financial condition, operations or cash flows.

We review all litigation on an ongoing basis when making accrual and disclosure decisions. For certain legal proceedings, we cannot reasonably estimate losses or a range of loss, if any, particularly for proceedings that are in their early stages of development or where the plaintiffs seek indeterminate damages. Various factors, including, but not limited to, the outcome of potentially lengthy discovery and the resolution of important factual questions, may need to be determined before probability can be established or before a loss or range of loss can be reasonably estimated. If the loss contingency in question is not both probable and reasonably estimable, we do not establish an accrual and the matter will continue to be monitored for any developments that would make the loss contingency both probable and reasonably estimable. In the event that a legal proceeding results in a substantial judgment against, or settlement by, us, there can be no assurance that any resulting liability or financial commitment would not have a material adverse effect on the financial condition, results of operations or cash flows of the Indemnity shareholder interest or the consolidated financial statements of Erie Indemnity Company.

Table of Contents

We are subject to escheatment laws and regulations requiring the identification, reporting and payment to the state of unclaimed or abandoned funds of our policyholders, annuitants, claimants and shareholders. We are also subject to audit and examination for compliance with these requirements.

In August 2012, we were notified that we would be subject to an audit of our compliance with the unclaimed property laws of a number of jurisdictions both within and outside our operating territory. The audit commenced in April 2013 and is ongoing. Additionally, EFL has been named in a lawsuit filed by the State Treasurer of West Virginia. The Complaint alleges that EFL has failed to comply with the West Virginia Uniform Unclaimed Property Act. EFL filed a motion to dismiss and a decision has not yet been rendered.

It is probable that ongoing inquiries, audits, and other regulatory activity will result in the payment of additional death claims and escheatment of funds, as well as possible fines. EFL will incur expenses to identify death claims, confirm that benefits are due and notify the beneficiaries. At this time, we are not able to reasonably estimate the possible loss or range of loss related to this issue due to the early stage of development.

## Note 15. Indemnity Supplemental Information

## Consolidating Statement of Financial Position

(in millions)	Erie Insurance Group At September 30, 2013			
	Indemnity shareholder interest	Exchange noncontrolling interest	Reclassifications and eliminations	Erie Insurance Group
<b>Assets</b>				
<b>Investments</b>				
Available-for-sale securities, at fair value:				
Fixed maturities	\$499	\$7,921	\$—	\$8,420
Equity securities	48	849	—	897
Trading securities, at fair value	0	2,945	—	2,945
Limited partnerships	158	979	—	1,137
Other invested assets	1	20	—	21
Total investments	706	12,714	—	13,420
Cash and cash equivalents	33	502	—	535
Premiums receivable from policyholders	—	1,203	—	1,203
Reinsurance recoverable	—	174	—	174
Deferred income tax asset	42	0	—	42
Deferred acquisition costs	—	574	—	574
Other assets	107	329	—	436
Receivables from the Exchange and other affiliates	320	—	(320	) —
Note receivable from EFL	25	—	(25	) —
Total assets	\$1,233	\$15,496	\$(345	) \$16,384
<b>Liabilities</b>				
Losses and loss expense reserves	\$—	\$3,712	\$—	\$3,712
Life policy and deposit contract reserves	—	1,754	—	1,754
Unearned premiums	—	2,654	—	2,654
Deferred income tax liability	0	368	—	368
Other liabilities	576	466	(345	) 697

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Total liabilities	576	8,954	(345	) 9,185
Shareholders' equity and noncontrolling interest				
Total Indemnity shareholders' equity	657	—	—	657
Noncontrolling interest in consolidated entity – Exchange	—	6,542	—	6,542
Total equity	657	6,542	—	7,199
Total liabilities, shareholders' equity and noncontrolling interest	\$1,233	\$15,496	\$(345	) \$16,384

37

---

Table of Contents

## Consolidating Statement of Financial Position

(in millions)	Erie Insurance Group At December 31, 2012			Erie Insurance Group
	Indemnity shareholder interest	Exchange noncontrolling interest	Reclassifications and eliminations	
Assets				
Investments				
Available-for-sale securities, at fair value:				
Fixed maturities	\$452	\$7,707	\$—	\$8,159
Equity securities	55	945	—	1,000
Trading securities, at fair value	0	2,417	—	2,417
Limited partnerships	180	1,037	—	1,217
Other invested assets	1	20	—	21
Total investments	688	12,126	—	12,814
Cash and cash equivalents	12	388	—	400
Premiums receivable from policyholders	—	1,062	—	1,062
Reinsurance recoverable	—	168	—	168
Deferred income tax asset	37	0	—	37
Deferred acquisition costs	—	504	—	504
Other assets	117	339	—	456
Receivables from the Exchange and other affiliates	281	—	(281	) —
Note receivable from EFL	25	—	(25	) —
Total assets	\$1,160	\$14,587	\$(306	) \$15,441
Liabilities				
Losses and loss expense reserves	\$—	\$3,598	\$—	\$3,598
Life policy and deposit contract reserves	—	1,708	—	1,708
Unearned premiums	—	2,365	—	2,365
Deferred income tax liability	0	365	—	365
Other liabilities	518	402	(306	) 614
Total liabilities	518	8,438	(306	) 8,650
Shareholders' equity and noncontrolling interest				
Total Indemnity shareholders' equity	642	—	—	642
Noncontrolling interest in consolidated entity – Exchange	—	6,149	—	6,149
Total equity	642	6,149	—	6,791
Total liabilities, shareholders' equity and noncontrolling interest	\$1,160	\$14,587	\$(306	) \$15,441

Receivables from the Exchange and EFL and concentrations of credit risk – Financial instruments could potentially expose Indemnity to concentrations of credit risk, including unsecured receivables from the Exchange. A majority of Indemnity's revenue and receivables are from the Exchange and affiliates. See also Note 4, "Variable Interest Entity."

Management fees and expense allocation amounts due from the Exchange were \$317 million and \$278 million at September 30, 2013 and December 31, 2012, respectively. The receivable from EFL for expense allocations and interest on the surplus note totaled \$3 million at September 30, 2013 and December 31, 2012.



Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Note receivable from EFL – Indemnity is due \$25 million from EFL in the form of a surplus note that was issued in 2003. The note may be repaid only out of unassigned surplus of EFL. Both principal and interest payments are subject to prior approval by the Pennsylvania Insurance Commissioner. The note bears an annual interest rate of 6.7% and will be payable on demand on or after December 31, 2018, with interest scheduled to be paid semi-annually, subject to prior approval by the Pennsylvania Insurance Commissioner. For the nine months ended September 30, 2013 and 2012, Indemnity recognized interest income on the note of \$1.3 million.

Table of Contents

## Income attributable to Indemnity shareholder interest

(in millions)	Indemnity Shareholder Interest			
	Three months ended		Nine months ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Management operations:				
Management fee revenue, net	\$333	\$305	\$965	\$882
Service agreement revenue	8	8	23	23
Total revenue from management operations	341	313	988	905
Cost of management operations	281	247	820	734
Income from management operations before taxes	60	66	168	171
Investment operations:				
Net investment income	4	4	11	12
Net realized gains on investments	1	2	1	4
Net impairment losses recognized in earnings	0	0	0	0
Equity in earnings of limited partnerships	5	6	13	10
Income from investment operations before taxes	10	12	25	26
Income from operations before income taxes	70	78	193	197
Provision for income taxes	24	27	66	67
Net income attributable to Indemnity	\$46	\$51	\$127	\$130

## Indemnity's components of direct cash flows as included in the Consolidated Statements of Cash Flows

(in millions)	Indemnity Shareholder Interest		
	Nine months ended		
	September 30,		
	2013	2012	
Management fee received	\$933	\$851	
Service agreement fee received	23	23	
Net investment income received	16	19	
Limited partnership distributions	18	11	
Decrease in reimbursements collected from affiliates	(8	) (2	)
Commissions and bonuses paid to agents	(521	) (470	)
Salaries and wages paid	(110	) (99	)
Pension contribution and employee benefits paid	(33	) (36	)
General operating expenses paid	(124	) (99	)
Income taxes paid	(62	) (54	)
Net cash provided by operating activities	132	144	
Net cash used in investing activities	(33	) (8	)
Net cash used in financing activities	(78	) (135	)
Net increase in cash and cash equivalents	21	1	
Cash and cash equivalents at beginning of period	12	11	
Cash and cash equivalents at end of period	\$33	\$12	

## Note 16. Subsequent Events

Other than Indemnity and the Exchange amending their respective bank revolving lines of credit on October 25, 2013, as discussed in Note 8. "Bank Line of Credit," no items were identified in this period subsequent to the financial statement date that required adjustment or additional disclosure.

39

---

Table of Contents

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

The following discussion of financial condition and results of operations highlights significant factors influencing the Erie Insurance Group ("we," "us," "our"). This discussion should be read in conjunction with the historical financial statements and the related notes thereto included in Item 1. "Financial Statements" of this Quarterly Report on Form 10-Q, and with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for the year ended December 31, 2012, as contained in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 26, 2013.

## INDEX

	Page Number
<u>Cautionary Statement Regarding Forward-Looking Information</u>	<u>40</u>
<u>Recent Accounting Pronouncements</u>	<u>41</u>
<u>Operating Overview</u>	<u>42</u>
<u>Results of Operations</u>	<u>48</u>
<u>Management Operations</u>	<u>48</u>
<u>Property and Casualty Insurance Operations</u>	<u>50</u>
<u>Life Insurance Operations</u>	<u>54</u>
<u>Investment Operations</u>	<u>55</u>
<u>Financial Condition</u>	<u>58</u>
<u>Investments</u>	<u>58</u>
<u>Liabilities</u>	<u>62</u>
<u>Impact of Inflation</u>	<u>63</u>
<u>Liquidity and Capital Resources</u>	<u>63</u>
<u>Critical Accounting Estimates</u>	<u>66</u>

## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995:

Statements contained herein that are not historical fact are forward-looking statements and, as such, are subject to risks and uncertainties that could cause actual events and results to differ, perhaps materially, from those discussed herein. Forward-looking statements relate to future trends, events or results and include, without limitation, statements and assumptions on which such statements are based that are related to our plans, strategies, objectives, expectations, intentions and adequacy of resources. Examples of forward-looking statements are discussions relating to premium and investment income, expenses, operating results, agency relationships, and compliance with contractual and regulatory requirements. Forward-looking statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Among the risks and uncertainties, in addition to those set forth in our filings with the Securities and Exchange Commission, that could cause actual results and future events to differ from those set forth or contemplated in the forward-looking statements include the following:

Risk factors related to the Erie Indemnity Company ("Indemnity") shareholder interest:

- dependence upon Indemnity's relationship with the Exchange and the management fee under the agreement with the subscribers at the Exchange;

- costs of providing services to the Exchange under the subscriber's agreement;
- ability to attract and retain talented management and employees;
- ability to maintain uninterrupted business operations, including information technology systems;
- factors affecting the quality and liquidity of Indemnity's investment portfolio;
- credit risk from the Exchange;
- Indemnity's ability to meet liquidity needs and access capital; and
- outcome of pending and potential litigation against Indemnity.

Table of Contents

Risk factors related to the non-controlling interest owned by the Erie Insurance Exchange (“Exchange”), which includes the Property and Casualty Group and Erie Family Life Insurance Company:

- general business and economic conditions;
- dependence upon the independent agency system;
  - ability to maintain our reputation for customer service;
- factors affecting insurance industry competition;
- changes in government regulation of the insurance industry;
- premium rates and reserves must be established from forecasts of ultimate costs;
- emerging claims, coverage issues in the industry, and changes in reserve estimates related to the property and casualty business;
- changes in reserve estimates related to the life business;
- severe weather conditions or other catastrophic losses, including terrorism;
- the Exchange’s ability to acquire reinsurance coverage and collectability from reinsurers;
- factors affecting the quality and liquidity of the Exchange’s investment portfolio;
- the Exchange’s ability to meet liquidity needs and access capital;
- the Exchange’s ability to maintain an acceptable financial strength rating;
- outcome of pending and potential litigation against the Exchange; and
- dependence upon the service provided by Indemnity.

A forward-looking statement speaks only as of the date on which it is made and reflects our analysis only as of that date. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events, changes in assumptions, or otherwise.

**RECENT ACCOUNTING PRONOUNCEMENTS**

See Item 1. “Financial Statements - Note 2. Significant Accounting Policies,” contained within this report for a discussion of adopted and/or pending accounting pronouncements, none of which are expected to have a material impact on our future financial condition, results of operations or cash flows.

Table of Contents

OPERATING OVERVIEW

Overview

The Erie Insurance Group represents the consolidated results of Indemnity and the results of its variable interest entity, the Exchange. The Erie Insurance Group operates predominantly as a property and casualty insurer through its regional insurance carriers that write a broad range of personal and commercial coverages. Our property and casualty insurance companies include the Exchange and its wholly owned subsidiaries, Erie Insurance Company (“EIC”), Erie Insurance Company of New York (“ENY”), Erie Insurance Property and Casualty Company (“EPC”), and Flagship City Insurance Company (“Flagship”). These entities operate collectively as the “Property and Casualty Group.” The Erie Insurance Group also operates as a life insurer through the Exchange’s wholly owned subsidiary, Erie Family Life Insurance Company (“EFL”), which underwrites and sells individual and group life insurance policies and fixed annuities.

The Exchange is a reciprocal insurance exchange organized under Article X of Pennsylvania's Insurance Company Law of 1921 under which individuals, partnerships and corporations are authorized to exchange reciprocal or inter-insurance contracts with each other, or with individuals, partnerships, and corporations of other states and countries, providing indemnity among themselves from any loss which may be insured against under any provision of the insurance laws except life insurance. Each applicant for insurance to the Exchange signs a subscriber’s agreement, which contains an appointment of Indemnity as their attorney-in-fact to transact the business of the Exchange on their behalf.

Pursuant to the subscriber’s agreement and for its services as attorney-in-fact, Indemnity earns a management fee calculated as a percentage of the direct premiums written by the Exchange and the other members of the Property and Casualty Group, which are assumed by the Exchange under an intercompany pooling arrangement.

The Indemnity shareholder interest includes Indemnity’s equity and income, but not the equity or income of the Exchange. The Exchange’s equity, which is comprised of its retained earnings and accumulated other comprehensive income, is held for the interest of its subscribers (policyholders) and meets the definition of a noncontrolling interest, which is reflected as such in our consolidated financial statements.

“Indemnity shareholder interest” refers to the interest in Erie Indemnity Company owned by the Class A and Class B shareholders. “Noncontrolling interest” refers to the interest in the Erie Insurance Exchange held for the interest of the subscribers (policyholders).

The Indemnity shareholder interest in income comprises:

- a management fee of up to 25% of all property and casualty insurance premiums written or assumed by the Exchange, less the costs associated with the sales, underwriting and issuance of these policies;
- net investment income and results on investments that belong to Indemnity; and
- other income and expenses, including income taxes, that are the responsibility of Indemnity.

The Exchange’s or the noncontrolling interest in income comprises:

- 100% interest in the net underwriting results of the property and casualty insurance operations;
- 100% interest in the net earnings of EFL's life insurance operations;

net investment income and results on investments that belong to the Exchange and its subsidiaries; and  
other income and expenses, including income taxes, that are the responsibility of the Exchange and its subsidiaries.

42

---



Table of Contents

## Results of the Erie Insurance Group's Operations by Interest (Unaudited)

The following tables represent a breakdown of the composition of the income attributable to the Indemnity shareholder interest and the income attributable to the noncontrolling interest (Exchange). For purposes of this discussion, EFL's investments are included in the life insurance operations.

Three months ended September 30, 2013

(in millions)	Indemnity shareholder interest		Noncontrolling interest (Exchange)		Eliminations of related party transactions		Erie Insurance Group	
	Three months ended September 30, 2013	2012	Three months ended September 30, 2013	2012	Three months ended September 30, 2013	2012	Three months ended September 30, 2013	2012
Management operations:								
Management fee revenue, net	\$ 333	\$ 305	\$—	\$—	\$(333 )	\$(305 )	\$—	\$—
Service agreement revenue	8	8	—	—	—	—	8	8
Total revenue from management operations	341	313	—	—	(333 )	(305 )	8	8
Cost of management operations	281	247	—	—	(281 )	(247 )	—	—
Income from management operations before taxes	60	66	—	—	(52 )	(58 )	8	8
Property and casualty insurance operations:								
Net premiums earned	—	—	1,221	1,118	—	—	1,221	1,118
Losses and loss expenses	—	—	841	890	(1 )	(2 )	840	888
Policy acquisition and underwriting expenses	—	—	356	329	(54 )	(59 )	302	270
Income (loss) from property and casualty insurance operations before taxes	—	—	24	(101 )	55	61	79	(40 )
Life insurance operations: <sup>(1)</sup>								
Total revenue	—	—	47	44	(1 )	0	46	44
Total benefits and expenses	—	—	37	32	0	0	37	32
Income from life insurance operations before taxes	—	—	10	12	(1 )	0	9	12
Investment operations:								
Net investment income	4	4	83	81	(2 )	(3 )	85	82
Net realized gains on investments	1	2	188	165	—	—	189	167
Net impairment losses recognized in earnings	0	0	(9 )	0	—	—	(9 )	0
Equity in earnings of limited partnerships	5	6	32	35	—	—	37	41
Income from investment operations before taxes	10	12	294	281	(2 )	(3 )	302	290
Income from operations before income taxes and noncontrolling interest	70	78	328	192	—	—	398	270
Provision for income taxes	24	27	107	59	—	—	131	86
Net income	\$ 46	\$ 51	\$ 221	\$ 133	\$—	\$—	\$ 267	\$ 184

Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes, the life insurance operations (1) in the table above include life insurance related investment results. However, the life insurance investment results are included in the investment operations segment discussion as part of the Exchange's investment results.

Net income in the third quarter of 2013 benefited from improved results in our property and casualty insurance and investment operations, compared to the third quarter of 2012.

The Exchange's property and casualty insurance operations experienced a 9.2% increase in earned premium in the third quarter of 2013, driven by increases in policies in force and the average premium per policy. Losses from the Exchange's property and casualty insurance operations decreased during the same period due to lower levels of catastrophe losses and slightly higher levels of favorable development on prior accident year loss reserves, compared to the third quarter of 2012.

Our investment operations were positively impacted by an increase in net realized gains on investments related to the sales of common stock in the third quarter of 2013, offset somewhat by net impairment losses recognized in earnings on an equity security in an unrealized loss position that we intend to sell, compared to the third quarter of 2012.

Table of Contents

Nine months ended September 30, 2013

(in millions)	Indemnity shareholder interest		Noncontrolling interest (Exchange)		Eliminations of related party transactions		Erie Insurance Group	
	Nine months ended September 30,		Nine months ended September 30,		Nine months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Management operations:								
Management fee revenue, net	\$ 965	\$ 882	\$—	\$—	\$(965 )	\$(882 )	\$—	\$—
Service agreement revenue	23	23	—	—	—	—	23	23
Total revenue from management operations	988	905	—	—	(965 )	(882 )	23	23
Cost of management operations	820	734	—	—	(820 )	(734 )	—	—
Income from management operations before taxes	168	171	—	—	(145 )	(148 )	23	23
Property and casualty insurance operations:								
Net premiums earned	—	—	3,573	3,279	—	—	3,573	3,279
Losses and loss expenses	—	—	2,495	2,501	(4 )	(4 )	2,491	2,497
Policy acquisition and underwriting expenses	—	—	1,032	963	(151 )	(153 )	881	810
Income (loss) from property and casualty insurance operations before taxes	—	—	46	(185 )	155	157	201	(28 )
Life insurance operations: <sup>(1)</sup>								
Total revenue	—	—	139	133	(2 )	(1 )	137	132
Total benefits and expenses	—	—	105	99	0	0	105	99
Income from life insurance operations before taxes	—	—	34	34	(2 )	(1 )	32	33
Investment operations:								
Net investment income	11	12	243	251	(8 )	(8 )	246	255
Net realized gains on investments	1	4	492	348	—	—	493	352
Net impairment losses recognized in earnings	0	0	(9 )	0	—	—	(9 )	0
Equity in earnings of limited partnerships	13	10	98	89	—	—	111	99
Income from investment operations before taxes	25	26	824	688	(8 )	(8 )	841	706
Income from operations before income taxes and noncontrolling interest	193	197	904	537	—	—	1,097	734
Provision for income taxes	66	67	297	167	—	—	363	234
Net income	\$ 127	\$ 130	\$ 607	\$ 370	\$—	\$—	\$ 734	\$ 500

Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes, the life insurance operations (1) in the table above include life insurance related investment results. However, the life insurance investment results are included in the investment operations segment discussion as part of the Exchange's investment results.

Net income in the first nine months of 2013 benefited from improved results in our property and casualty insurance and investment operations, compared to the first nine months of 2012.

The Exchange's property and casualty insurance operations experienced an 8.9% increase in earned premium in the first nine months of 2013, driven by increases in policies in force and the average premium per policy. Losses from the Exchange's property and casualty insurance operations decreased slightly during the same period due to lower levels of catastrophe losses, offset by increased current accident year, non-catastrophe losses and less favorable development on prior accident year loss reserves, compared to the first nine months of 2012.

Our investment operations were positively impacted by generating higher levels of net realized gains on investments primarily related to the sales of common stock in the first nine months of 2013, compared to the first nine months of 2012. Additionally, equity in earnings of limited partnerships increased slightly during the same period due to higher earnings from real estate investments, while net investment income decreased slightly primarily related to lower investment yields and net impairment losses recognized in earnings increased, compared to the first nine months of 2012.

Table of Contents

## Reconciliation of Operating Income to Net Income (Unaudited)

We disclose operating income, a non-GAAP financial measure, to enhance our investors' understanding of our performance related to the Indemnity shareholder interest. Our method of calculating this measure may differ from those used by other companies, and therefore comparability may be limited.

Indemnity defines operating income as net income excluding realized capital gains and losses, impairment losses and related federal income taxes.

Indemnity uses operating income to evaluate the results of its operations. It reveals trends that may be obscured by the net effects of realized capital gains and losses including impairment losses. Realized capital gains and losses, including impairment losses, may vary significantly between periods and are generally driven by business decisions and economic developments such as capital market conditions which are not related to our ongoing operations. We are aware that the price to earnings multiple commonly used by investors as a forward-looking valuation technique uses operating income as the denominator. Operating income should not be considered as a substitute for net income prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and does not reflect Indemnity's overall profitability.

The following table reconciles operating income and net income for the Indemnity shareholder interest:

(in millions, except per share data)	Indemnity Shareholder Interest				
	Three months ended		Nine months ended		
	September 30, 2013 (Unaudited)	2012	September 30, 2013 (Unaudited)	2012	
Operating income attributable to Indemnity	\$45	\$50	\$126	\$128	
Net realized gains and impairments on investments	1	2	1	4	
Income tax expense	0	(1	) 0	(2	)
Realized gains and impairments, net of income taxes	1	1	1	2	
Net income attributable to Indemnity	\$46	\$51	\$127	\$130	
Per Indemnity Class A common share-diluted:					
Operating income attributable to Indemnity	\$0.86	\$0.93	\$2.40	\$2.38	
Net realized gains and impairments on investments	0.01	0.05	0.01	0.08	
Income tax expense	0.00	(0.02	) 0.00	(0.03	)
Realized gains and impairments, net of income taxes	0.01	0.03	0.01	0.05	
Net income attributable to Indemnity	\$0.87	\$0.96	\$2.41	\$2.43	

## Summary of Results – Indemnity Shareholder Interest

## Three months ended September 30, 2013

Net income attributable to Indemnity per share-diluted was \$0.87 per share in the third quarter of 2013, compared to \$0.96 per share in the third quarter of 2012.

Operating income attributable to Indemnity per share-diluted (excluding net realized gains or losses, impairments on investments and related taxes) was \$0.86 per share in the third quarter of 2013, compared to \$0.93 per share in the third quarter of 2012.

## Nine months ended September 30, 2013

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Net income attributable to Indemnity per share-diluted was \$2.41 per share for the nine months ended September 30, 2013, compared to \$2.43 per share for the nine months ended September 30, 2012.

Operating income attributable to Indemnity per share-diluted (excluding net realized gains or losses, impairments on investments and related taxes) was \$2.40 per share for the nine months ended September 30, 2013, compared to \$2.38 per share for the nine months ended September 30, 2012.

## Table of Contents

### Operating Segments

Our reportable segments include management operations, property and casualty insurance operations, life insurance operations and investment operations.

### Management operations

Management operations generate internal management fee revenue, which accrues to the Indemnity shareholder interest, as Indemnity provides services relating to the sales, underwriting and issuance of policies on behalf of the Exchange. Management fee revenue is based upon all premiums written or assumed by the Exchange and the management fee rate, which is not to exceed 25%. Our Board of Directors establishes the management fee rate at least annually, generally in December for the following year, and considers factors such as the relative financial strength of Indemnity and the Exchange and projected revenue streams. The management fee rate was set at 25% for both 2013 and 2012. Management fee revenue is eliminated upon consolidation.

### Property and casualty insurance operations

The property and casualty insurance business is driven by premium growth, the combined ratio and investment returns. The property and casualty insurance industry is cyclical, with periods of rising premium rates and shortages of underwriting capacity followed by periods of substantial price competition and excess capacity. The cyclical nature of the insurance industry has a direct impact on the direct written premium of the Property and Casualty Group.

The property and casualty insurance operation's premium growth strategy focuses on growth by expansion of existing operations including a careful agency selection process and increased market penetration in existing operating territories. Expanding the size of our existing agency force of nearly 2,200 independent agencies, with over 10,700 licensed property and casualty representatives, will contribute to future growth as new agents build their books of business with the Property and Casualty Group.

Geographic expansion is also a component of the Property and Casualty Group's premium growth strategy. The Property and Casualty Group plans to expand operations into the Commonwealth of Kentucky by early 2015.

The property and casualty insurance operations insure preferred and standard risks while maintaining a disciplined underwriting approach. Based upon direct written premium in 2012, 45% of our premiums were derived from personal auto, 26% from homeowners and 29% from commercial lines. Pennsylvania, Maryland and Virginia made up 62% of the property and casualty lines insurance business 2012 direct written premium.

Members of the Property and Casualty Group pool their underwriting results under an intercompany pooling agreement. Under the pooling agreement, the Exchange retains a 94.5% interest in the net underwriting results of the Property and Casualty Group, while EIC retains a 5.0% interest and ENY retains a 0.5% interest.

The key measure of underwriting profitability traditionally used in the property and casualty insurance industry is the combined ratio, which is expressed as a percentage. It is the sum of the ratio of losses and loss expenses to premiums earned (loss ratio) plus the ratio of policy acquisition and other underwriting expenses to premiums earned (expense ratio). When the combined ratio is less than 100%, underwriting results are generally considered profitable; when the combined ratio is greater than 100%, underwriting results are generally considered unprofitable.

Factors affecting losses and loss expenses include the frequency and severity of losses, the nature and severity of catastrophic losses, the quality of risks underwritten and underlying claims and settlement expenses.

Investments held by the Property and Casualty Group are reported in the investment operations segment, separate from the underwriting business.

Life insurance operations

EFL generates revenues through the sale of its individual and group life insurance policies and fixed annuities. These products provide our property and casualty agency force an opportunity to cross-sell both personal and commercial accounts. EFL's profitability depends principally on the ability to develop, price and distribute insurance products, attract and retain deposit funds, generate investment returns and manage expenses. Other drivers include mortality and morbidity experience, persistency experience to enable the recovery of acquisition costs, maintenance of interest spreads over the amounts credited to deposit funds and the maintenance of strong ratings from rating agencies. EFL plans to expand operations into the Commonwealth of Kentucky by early 2015.



## Table of Contents

Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes, the life insurance operations segment discussion includes the life insurance related investment results. However, also for presentation purposes, the segment footnote and the investment operations segment discussion also include the life insurance investment results as part of the Exchange's investment results.

### Investment operations

We generate revenues from our fixed maturity, equity security and limited partnership investment portfolios to support our underwriting business. The Indemnity and Exchange portfolios are managed with the objective of maximizing after-tax returns on a risk-adjusted basis, while the EFL portfolio is managed to be closely aligned to its liabilities and to maintain a sufficient yield to meet profitability targets. Management actively evaluates the portfolios for impairments. We record impairment writedowns on investments in instances where the fair value of the investment is substantially below cost, and we conclude that the decline in fair value is other-than-temporary, which includes consideration for intent to sell.

Earnings from our investment operations increased in the third quarter of 2013, compared to the third quarter of 2012. Net realized gains totaled \$191 million in the third quarter of 2013, compared to gains of \$169 million in the prior year quarter, primarily reflecting an increase in net realized gains from sales of common stock in the third quarter of 2013. Net investment income totaled \$109 million in the third quarter of 2013, compared to \$105 million in the third quarter of 2012. Equity in earnings of limited partnerships was \$37 million in the third quarter of 2013, compared to \$41 million in the third quarter of 2012. The results from our limited partnerships are based upon financial statements received from our general partners, which are generally received on a quarter lag. As a result, our third quarter 2013 partnership earnings reflect the market conditions experienced in the second quarter of 2013.

### General Conditions and Trends Affecting Our Business

#### Economic conditions

Unfavorable changes in economic conditions, including declining consumer confidence, inflation, high unemployment and the threat of recession, among others, may lead the Property and Casualty Group's customers to modify coverage, not renew policies, or even cancel policies, which could adversely affect the premium revenue of the Property and Casualty Group, and consequently Indemnity's management fee. These conditions could also impair the ability of customers to pay premiums when due, and as a result, the Property and Casualty Group's bad debt write-offs could increase. Our key challenge is to generate profitable revenue growth in a highly competitive market that continues to experience the effects of uncertain economic conditions.

#### Financial market volatility

Our portfolio of fixed income, preferred and common stocks, and limited partnerships are subject to market volatility especially in periods of instability in the worldwide financial markets. Over time, net investment income could also be impacted by volatility and by the general level of interest rates, which impact reinvested cash flow from the portfolio and business operations. Depending upon market conditions, which are unpredictable and remain uncertain, considerable fluctuation could exist in our reported total investment income, which could have an adverse impact on our financial condition, results of operations and cash flows.

Table of Contents

## RESULTS OF OPERATIONS

The information that follows is presented on a segment basis prior to eliminations.

## Management Operations

Management fee revenue is earned by Indemnity from services relating to the sales, underwriting and issuance of policies on behalf of the Exchange as a result of its attorney-in-fact relationship, and is eliminated upon consolidation. A summary of the results of our management operations is as follows:

(dollars in millions)	Indemnity Shareholder Interest Three months ended September 30,			Nine months ended September 30,		
	2013 (Unaudited)	2012	% Change	2013 (Unaudited)	2012	% Change
Management fee revenue, net	\$333	\$305	9.3 %	\$965	\$882	9.5 %
Service agreement revenue	8	8	5.1	23	23	1.5
Total revenue from management operations	341	313	9.2	988	905	9.3
Cost of management operations	281	247	13.5	820	734	11.7
Income from management operations – Indemnity <sup>(1)</sup>	\$60	\$66	(7.3 )%	\$168	\$171	(1.1 )%
Gross margin	17.7 %	20.9 %	(3.2 )pts.	17.1 %	18.8 %	(1.7 )pts.

(1) The Indemnity shareholder interest retains 100% of the income from the management operations.

## Management fee revenue

Management fee revenue is based upon all premiums written or assumed by the Exchange and the management fee rate, which is determined by our Board of Directors at least annually. Management fee revenue is calculated by multiplying the management fee rate by the direct premiums written by the Exchange and the other members of the Property and Casualty Group, which are assumed by the Exchange under an intercompany pooling agreement. The following table presents the calculation of management fee revenue:

(dollars in millions)	Indemnity Shareholder Interest Three months ended September 30,			Nine months ended September 30,		
	2013 (Unaudited)	2012	% Change	2013 (Unaudited)	2012	% Change
Property and Casualty Group direct written premium	\$1,332	\$1,215	9.6 %	\$3,873	\$3,532	9.6 %
Management fee rate	25 %	25 %		25 %	25 %	
Management fee revenue, gross	333	304	9.6	968	883	9.6
Change in allowance for management fee returned on cancelled policies <sup>(1)</sup>	0	1	NM	(3 )	(1 )	NM
Management fee revenue, net of allowance	\$333	\$305	9.3 %	\$965	\$882	9.5 %

NM = not meaningful

(1) Management fees are returned to the Exchange when policies are cancelled mid-term and unearned premiums are refunded. We record an estimated allowance for management fees returned on mid-term policy cancellations.

Direct written premium of the Property and Casualty Group increased 9.6% in the third quarter of 2013, compared to the third quarter of 2012, due to a 4.7% increase in policies in force and a 4.7% increase in the year-over-year average premium per policy for all lines of business. The year-over-year policy retention ratio was 90.7% at September 30, 2013, 90.9% at December 31, 2012, and 90.8% at September 30, 2012. See the “Property and Casualty Insurance Operations” segment that follows for a complete discussion of property and casualty direct written premium, which has a direct bearing on Indemnity’s management fee.

The management fee rate was set at 25%, the maximum rate, for both 2013 and 2012. Changes in the management fee rate can affect the Indemnity shareholder interest's revenue and net income from this segment significantly.

Table of Contents

## Service agreement revenue

Service agreement revenue includes service charges Indemnity collects from policyholders for providing extended payment terms on policies written by the Property and Casualty Group and late payment and policy reinstatement fees. The service charges are fixed dollar amounts per billed installment. Service agreement revenue remained relatively flat, totaling \$8 million in both the third quarters of 2013 and 2012, and \$23 million for both the nine months ended September 30, 2013 and 2012. The consistency in the service fee revenue compared to the growth in policies in force reflects the continued shift in policies to the monthly direct debit payment plan, which does not incur service charges, and the no-fee single payment plan, which offers a premium discount. The shift to these plans is driven by the consumers' desire to avoid paying service charges and to take advantage of the discount in pricing offered for paid-in-full policies.

## Cost of management operations

(in millions)	Indemnity Shareholder Interest			Interest			
	Three months ended September 30,			Nine months ended September 30,			
	2013	2012	% Change	2013	2012	% Change	
	(Unaudited)			(Unaudited)			
Commissions	\$187	\$163	14.4	% \$538	\$477	12.7	%
Non-commission expense	94	84	11.9	282	257	9.8	
Total cost of management operations	\$281	\$247	13.5	% \$820	\$734	11.7	%

Commissions – Commissions increased \$24 million in the third quarter of 2013 and \$61 million for the nine months ended September 30, 2013, compared to the same respective periods in 2012. These increases were primarily a result of increased base commissions due to the 9.6% increase in direct written premium of the Property and Casualty Group for both respective periods. Agent bonuses also increased due to an increase in the profitability component of the bonus as a result of factoring in the most recent year's underwriting results and the increased premium levels of the Property and Casualty Group. Additionally, impacting the nine months ended September 30, 2012 was an adjustment that reduced commission expense by \$6 million that occurred in the second quarter of 2012. This amount represents the reimbursement by the North Carolina Reinsurance Facility (NCRF) for commissions Indemnity paid to agents on the surcharges collected on behalf of the NCRF which was incorrectly recorded as a benefit to the Exchange in prior periods.

Non-commission expense – Non-commission expense increased \$10 million in the third quarter of 2013, compared to the third quarter of 2012. Sales, policy issuance, advertising, and underwriting costs increased \$2 million. Personnel costs increased \$4 million as a result of a \$1 million increase in salaries, a \$1 million increase in pension costs, and a \$2 million increase in the estimate for incentive plan compensation related to growth and underwriting performance. All other operating costs increased \$4 million.

Non-commission expense increased \$25 million in the nine months ended September 30, 2013, compared to the nine months ended September 30, 2012. Sales, policy issuance, advertising, and underwriting costs increased \$5 million. Personnel costs increased \$13 million as a result of a \$4 million increase in salaries, a \$4 million increase in pension and medical costs, and a \$5 million increase in the estimate for incentive plan compensation related to growth and underwriting performance. All other operating costs increased \$7 million, which included a \$2 million increase in professional fees and a \$1 million increase in software costs.

## Gross margin

The gross margin in the third quarter of 2013 was 17.7%, compared to 20.9% in the third quarter of 2012, and was 17.1% for the nine months ended September 30, 2013, compared to 18.8% for the nine months ended September 30,

2012. Excluding the adjustment that reduced commission expense by \$6 million that occurred in the second quarter of 2012, the gross margin would have been 18.2% for the nine months ended September 30, 2012.

Table of Contents

## Property and Casualty Insurance Operations

The Property and Casualty Group operates in 11 Midwestern, Mid-Atlantic and Southeastern states and the District of Columbia and primarily writes private passenger automobile, homeowners, commercial multi-peril, commercial automobile, and workers compensation lines of insurance. A summary of the results of our property and casualty insurance operations is as follows:

(dollars in millions)	Property and Casualty Group					
	Three months ended September 30, 2013 (Unaudited)			Nine months ended September 30, 2012 (Unaudited)		
Premiums:						
Direct written premium	\$1,332	\$1,215	9.6 %	\$3,873	\$3,532	9.6 %
Reinsurance – assumed and ceded	(7 )	(8 )	4.6	(23 )	(22 )	(6.0 )
Net written premium	1,325	1,207	9.7	3,850	3,510	9.7
Change in unearned premium	104	89	16.0	277	231	19.8
Net premiums earned	1,221	1,118	9.2	3,573	3,279	8.9
Losses and loss expenses:						
Current accident year, excluding catastrophe losses	815	794	2.9	2,372	2,200	7.9
Current accident year catastrophe losses	70	114	(38.9 )	142	343	(58.7 )
Prior accident years, including prior year catastrophe losses	(44 )	(18 )	NM	(19 )	(42 )	55.7
Losses and loss expenses	841	890	(5.3 )	2,495	2,501	(0.2 )
Policy acquisition and other underwriting expenses	356	329	8.3	1,032	963	7.2
Total losses and expenses	1,197	1,219	(1.6 )	3,527	3,464	1.8
Underwriting income (loss) – Exchange <sup>(1)</sup>	\$24	\$(101 )	NM %	\$46	\$(185 )	NM %
Loss and loss expense ratios:						
Current accident year loss ratio, excluding catastrophe losses	66.8 %	70.9 %	(4.1 )pts.	66.3 %	67.0 %	(0.7 )pts.
Current accident year catastrophe loss ratio	5.7	10.2	(4.5 )	4.0	10.5	(6.5 )
Prior accident year loss ratio, including prior year catastrophe losses	(3.6 )	(1.6 )	(2.0 )	(0.5 )	(1.3 )	0.8
Total loss and loss expense ratio	68.9	79.5	(10.6 )	69.8	76.2	(6.4 )
Policy acquisition and other underwriting expense ratio	29.2	29.4	(0.2 )	28.9	29.4	(0.5 )
Combined ratio	98.1 %	108.9 %	(10.8 )pts.	98.7 %	105.6 %	(6.9 )pts.

NM = not meaningful

(1) The Exchange retains 100% of the income from the property and casualty insurance operations.

We measure profit or loss from our property and casualty insurance segment based upon its underwriting results, which are represented by net premiums earned less losses and loss expenses and policy acquisition and other underwriting expenses on a pre-tax basis. The loss and loss expense ratio and combined ratio are key performance indicators that we use to assess business trends and to make comparisons to industry results. The investment results related to our property and casualty insurance operations are included in our investment operations segment discussion.

Premiums

Direct written premium – Direct written premium of the Property and Casualty Group increased 9.6% to \$1.3 billion in the third quarter of 2013, from \$1.2 billion in the third quarter of 2012, driven by an increase in policies in force and increases in average premium per policy. Year-over-year policies in force for all lines of business increased by 4.7% in the third quarter of 2013 as the result of continuing strong policyholder retention and an increase in new policies written, compared to an increase of 3.4% in the third quarter of 2012. The year-over-year average premium per policy for all lines of business increased 4.7% at September 30, 2013, compared to 4.1% at September 30, 2012. The combined impact of these increases was seen primarily in our renewal business and personal lines new business premiums.

Premiums generated from new business increased 21.8% to \$174 million in the third quarter of 2013, compared to an increase of 17.8% to \$142 million in the third quarter of 2012. Underlying the trend in new business premiums was a 19.4% increase in new business policies written in the third quarter of 2013, compared to 10.0% in the third quarter of 2012, while the year-over-

Table of Contents

year average premium per policy on new business increased 3.3% at September 30, 2013, compared to 7.5% at September 30, 2012.

Premiums generated from renewal business increased 8.0% to \$1.2 billion in the third quarter of 2013, compared to an increase of 7.5% to \$1.1 billion in the third quarter of 2012. Underlying the trend in renewal business premiums were increases in average premium per policy and steady policy retention trends. The renewal business year-over-year average premium per policy increased 5.0% at September 30, 2013, compared to 3.7% at September 30, 2012. The Property and Casualty Group's year-over-year policy retention ratio was 90.7% at September 30, 2013, 90.9% at December 31, 2012, and 90.8% at September 30, 2012.

Personal lines – Total personal lines premiums written increased 8.9% to \$984 million in the third quarter of 2013, from \$903 million in the third quarter of 2012, driven by an increase of 4.7% in the total personal lines policies in force and an increase of 3.9% in the total personal lines year-over-year average premium per policy.

New business premiums written on personal lines increased 28.4% in the third quarter of 2013, compared to 17.4% in the third quarter of 2012, driven by increases in new business policies written and average premium per policy. Personal lines new business policies written increased 21.1% in the third quarter of 2013, compared to 12.1% in the third quarter of 2012, while the year-over-year average premium per policy on personal lines new business increased 5.2% at September 30, 2013, compared to 4.8% at September 30, 2012.

Private passenger auto new business premiums written increased 32.3% in the third quarter of 2013, compared to 10.0% in the third quarter of 2012. New business policies written for private passenger auto increased 27.1% in the third quarter of 2013, compared to 5.3% in the third quarter of 2012, while the new business year-over-year average premium per policy for private passenger auto increased 3.3% at September 30, 2013, compared to 3.6% at September 30, 2012.

Homeowners new business premiums written increased 22.9% in the third quarter of 2013, compared to 30.4% in the third quarter of 2012. New business policies written for homeowners increased 16.3% in the third quarter of 2013, compared to 18.1% in the third quarter of 2012. The new business year-over-year average premium per policy for homeowners increased 7.2% at September 30, 2013, compared to 9.2% at September 30, 2012.

Renewal premiums written on personal lines increased 6.7% in the third quarter of 2013, compared to 6.5% in the third quarter of 2012, driven by increases in average premium per policy and steady policy retention trends. The year-over-year average premium per policy on personal lines renewal business increased 3.9% at September 30, 2013, compared to 3.1% at September 30, 2012. The personal lines year-over-year policy retention ratio was 91.3% at September 30, 2013, 91.6% at December 31, 2012, and 91.5% at September 30, 2012.

Private passenger auto renewal premiums written increased 4.1% in the third quarter of 2013, compared to 3.6% in the third quarter of 2012. The year-over-year average premium per policy on private passenger auto renewal business increased 1.6% at September 30, 2013, compared to 0.8% at September 30, 2012. The private passenger auto year-over-year policy retention ratio was 92.1% at September 30, 2013 and December 31, 2012, and 92.0% at September 30, 2012.

Homeowners renewal premiums written increased 11.0% in the third quarter of 2013, compared to 11.8% in the third quarter of 2012. The year-over-year average premium per policy on homeowners renewal business increased 8.6% at September 30, 2013, compared to 8.4% at September 30, 2012. The homeowners year-over-year policyholder retention ratio was 90.3% at September 30, 2013, and 90.9% at December 31, 2012 and September 30, 2012.



Commercial lines – Total commercial lines premiums written increased 11.7% to \$348 million in the third quarter of 2013, from \$312 million in the third quarter of 2012, driven by a 5.0% increase in the total commercial lines policies in force and a 6.7% increase in the total commercial lines year-over-year average premium per policy.

New business premiums written on commercial lines increased 9.8% in the third quarter of 2013, compared to 18.4% in the third quarter of 2012, driven by increases in new business policies written and average premium per policy. The combined impact of these increases was seen primarily in the commercial multi-peril and commercial auto lines of business. Commercial lines new business policies written increased 10.2% in the third quarter of 2013, compared to 0.2% in the third quarter of 2012, while the year-over-year average premium per policy on commercial lines new business increased 5.9% at September 30, 2013, compared to 15.4% at September 30, 2012.

Table of Contents

Renewal premiums for commercial lines increased 12.0% in the third quarter of 2013, compared to an increase of 10.6% in the third quarter of 2012, driven by increases in average premium per policy and steady policy retention trends. The combined impact of these increases was seen primarily in the commercial multi-peril line of business, and to a lesser extent in the workers compensation and commercial auto lines of business. The year-over-year average premium per policy on commercial lines renewal business increased 6.9% at September 30, 2013, compared to 4.4% at September 30, 2012. The year-over-year policy retention ratio for commercial lines was 86.5% at September 30, 2013, 86.2% at December 31, 2012 and 86.0% at September 30, 2012.

Future trends — premium revenue – We plan to continue our efforts to grow Property and Casualty Group premiums and improve our competitive position in the marketplace. Expanding the size of our agency force through a careful agency selection process and increased market penetration in our existing operating territories will contribute to future growth as existing and new agents build their books of business with the Property and Casualty Group. At September 30, 2013, we had nearly 2,200 agencies with over 10,700 licensed property and casualty representatives.

Changes in premium levels attributable to the growth in policies in force and rate changes directly affect the profitability of the Property and Casualty Group and have a direct bearing on Indemnity's management fee. Our continued focus on underwriting discipline and the maturing of our pricing sophistication models have contributed to the Property and Casualty Group's growth in new policies in force and steady policy retention ratios.

Losses and loss expenses

Current accident year, excluding catastrophe losses – The current accident year loss and loss expense ratio for all lines of business, excluding catastrophe losses, was 66.8% in the third quarter of 2013, compared to 70.9% in the third quarter of 2012, and was 66.3% for the nine months ended September 30, 2013, compared to 67.0% for the nine months ended September 30, 2012.

Current accident year catastrophe losses – Catastrophic events, destructive weather patterns, or changes in climate conditions are an inherent risk of the property and casualty insurance business and can have a material impact on our property and casualty insurance underwriting results. In addressing this risk, we employ what we believe are reasonable underwriting standards and monitor our exposure by geographic region. The Property and Casualty Group's definition of catastrophes includes those weather-related or other loss events that we consider significant to our geographic footprint which, individually or in the aggregate, may not reach the level of a national catastrophe as defined by the Property Claim Service ("PCS"). The Property and Casualty Group maintains property catastrophe reinsurance coverage from unaffiliated reinsurers to mitigate future potential catastrophe loss exposures and no longer participates in the voluntary assumed reinsurance business, which lowers the variability of the Property and Casualty Group's underwriting results.

Catastrophe losses for the current accident year, as defined by the Property and Casualty Group, totaled \$70 million in the third quarter of 2013, compared to \$114 million in the third quarter of 2012, and contributed 5.7 points and 10.2 points, respectively, to the loss ratios. Catastrophe losses primarily included flooding, hail, tornado, and wind storms that occurred in July in the states of Ohio, Pennsylvania and Wisconsin in the third quarter of 2013, and in Pennsylvania, Indiana, North Carolina, and Ohio in the third quarter of 2012. For the nine months ended September 30, 2013, catastrophe losses for the current accident year totaled \$142 million, compared to \$343 million for the nine months ended September 30, 2012, and contributed 4.0 points and 10.5 points, respectively, to the loss ratios.

Prior accident years, including prior accident year catastrophe losses – The following table provides a breakout of our property and casualty insurance operation's prior year loss reserve development, including prior accident year catastrophe loss reserves, by type of business:

Property and Casualty Group

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

(in millions)	Three months ended September 30,		Nine months ended September 30,		
	2013	2012	2013	2012	
	(Unaudited)		(Unaudited)		
Direct business, including reserves for catastrophe losses and salvage and subrogation	\$(45	) \$(15	) \$(16	) \$(33	)
Assumed reinsurance business	2	(3	) 5	(3	)
Ceded reinsurance business	(1	) 0	(8	) (6	)
Total prior year loss development	\$(44	) \$(18	) \$(19	) \$(42	)

Negative amounts represent a redundancy (decrease in reserves), while positive amounts represent a deficiency (increase in reserves).

Table of Contents

Direct business, including reserves for catastrophe losses and salvage and subrogation – In the third quarter of 2013, the Property and Casualty Group experienced favorable development on direct prior accident year loss reserves of \$45 million that improved the combined ratio by 3.7 points, compared to \$15 million in the third quarter of 2012 that improved the combined ratio by 1.3 points. For the nine months ended September 30, 2013, favorable development of direct prior accident year loss reserves totaled \$16 million and improved the combined ratio by 0.5 points, compared to \$33 million and 1.0 points for the nine months ended September 30, 2012.

In the third quarter of 2013, minor favorable development was experienced across all major lines of business, whereas in the first nine months of 2013, the favorable development primarily related to the homeowners and personal auto lines of business. In the third quarter and first nine months of 2012, the favorable development primarily related to the commercial multi-peril and homeowners lines of business, offset somewhat by adverse development in the personal auto and workers compensation lines of business.

Assumed reinsurance – The Property and Casualty Group experienced adverse development on prior accident year loss reserves for its assumed involuntary reinsurance business totaling \$2 million in the third quarter of 2013, compared to favorable development of \$3 million in the third quarter of 2012. In the first nine months of 2013, adverse development on prior accident year loss reserves for the assumed reinsurance business totaled \$5 million, compared to favorable development of \$3 million in the first nine months of 2012.

Ceded reinsurance – The Property and Casualty Group’s ceded reinsurance reserve recoveries increased by \$1 million and were flat in the third quarters of 2013 and 2012, respectively, and increased by \$8 million and \$6 million in the first nine months of 2013 and 2012, respectively. The increase in ceded recoveries is reflected as favorable loss development as it represents an increase in recoveries resulting from adverse development on our direct loss reserves. In the first nine months of 2013, the increase in ceded recoveries was primarily due to adverse development related to the pre-1986 automobile massive injury claims and in the commercial multi-peril and business catastrophe liability lines of business, whereas the increase in the first nine months of 2012 was primarily due to adverse development related to the pre-1986 automobile massive injury claims.

Policy acquisition and other underwriting expenses – Our policy acquisition and other underwriting expense ratio decreased 0.2 points to 29.2% in the third quarter of 2013, from 29.4% in the third quarter of 2012, and decreased 0.5 points to 28.9% for the nine months ended September 30, 2013, from 29.4% for the nine months ended September 30, 2012. The 2012 policy acquisition and other underwriting expenses include a charge related to the adoption, on a prospective basis, of the new accounting guidance effective in 2012 related to the lower level of policy acquisition expenses eligible to be deferred. Additionally, the nine months ended September 30, 2012 included an adjustment of \$4 million which occurred in the second quarter of 2012 and contributed 0.1 points to the combined ratio at September 30, 2012. The adjustment represents the reimbursement by the North Carolina Reinsurance Facility (NCRF) for commissions Indemnity paid to agents on the surcharges collected on behalf of the NCRF which was incorrectly recorded as a benefit to the Exchange in prior periods. The management fee rate was 25% for the periods ended September 30, 2013 and 2012.

Table of Contents

## Life Insurance Operations

EFL is a Pennsylvania-domiciled life insurance company which underwrites and sells individual and group life insurance policies and fixed annuities and operates in 10 states and the District of Columbia. A summary of the results of our life insurance operations is as follows:

(in millions)	Erie Family Life Insurance Company							
	Three months ended September 30,			Nine months ended September 30,				
	2013 (Unaudited)	2012	% Change	2013 (Unaudited)	2012	% Change		
Individual life premiums, net of reinsurance	\$20	\$18	6.4	% \$58	\$53	8.2	%	
Group life and other premiums	1	1	2.4		2	3.1		
Other revenue	0	0	(16.3	)	1	(12.8	)	
Total net policy revenue	21	19	5.9		61	56	7.6	
Net investment income	24	23	0.2		70	71	(0.9	)
Net realized gains on investments	2	2	29.5		8	6	17.2	
Impairment losses recognized in earnings	0	0	NM		(1	) 0	NM	
Equity in earnings of limited partnerships	0	0	(49.2	)	1	0	NM	
Total revenues	47	44	2.7		139	133	3.7	
Benefits and other changes in policy reserves	28	24	13.3		80	74	7.8	
Amortization of deferred policy acquisition costs	3	3	(3.0	)	9	10	(5.2	)
Other operating expenses	6	5	12.3		16	15	1.4	
Total benefits and expenses	37	32	11.5		105	99	5.5	
Income before taxes – Exchange <sup>(1)</sup>	\$10	\$12	(22.3	)%	\$34	\$34	(1.7	)%

NM = not meaningful

(1) The Exchange retains 100% of the income from the life insurance operations.

## Policy revenue

Gross policy revenues increased 3.6% to just over \$29 million in the third quarter 2013, from nearly \$29 million in the third quarter of 2012. EFL uses, and has used, a variety of reinsurance programs to reduce claims volatility and for other financial benefits. While the amount of risk that EFL retains can vary based upon the type of policy issued and the year it was issued, EFL generally does not retain more than \$1 million of risk on any individual life. Ceded reinsurance premiums totaled \$9 million in both the third quarters of 2013 and 2012. For the nine months ended September 30, 2013, compared to 2012, gross policy revenues totaled \$89 million and \$86 million, respectively, while ceded reinsurance premiums totaled \$30 million for both respective periods.

Premiums received on annuity and universal life products totaled \$18 million in both the third quarters of 2013 and 2012. Of these amounts, annuity and universal life premiums, which are recorded as deposits and therefore not reflected in revenue on the Consolidated Statements of Operations, totaled \$13 million and \$14 million in the third quarters of 2013 and 2012, respectively. For the nine months ended September 30, 2013, compared to 2012, premiums received on annuity and universal life products totaled \$58 million for both respective periods, while annuity and universal life deposits totaled \$45 million and \$46 million, respectively.

## Investment revenue

In the third quarter of 2013, EFL experienced a slight increase in net investment income due to higher invested balances, compared to the third quarter of 2012. During the first nine months of 2013, EFL experienced an increase in net realized gains on investments due to increased call activity on preferred stocks, and a slight decrease in net investment income due to lower investment yields. EFL also recorded an increase in equity in earnings of limited partnerships during the first nine months of 2013, which was offset by an increase in impairment losses recognized in earnings due to two bond impairments. See the discussion of investments in the “Investment Operations” segment that follows for further information.

#### Benefits and expenses

In the third quarter and first nine months of 2013, total benefits and expenses were primarily impacted by an increase in benefits and other changes in policy reserves as a result of increases in death benefits and future policy benefits compared to the third quarter and first nine months of 2012.

Table of Contents

## Investment Operations

The investment results related to our life insurance operations are included in the investment operations segment discussion as part of the Exchange's investment results. A summary of the results of our investment operations is as follows:

(in millions)	Erie Insurance Group			Nine months ended September 30,			
	Three months ended September 30,			2013			
	2013	2012	% Change	2013	2012	% Change	
	(Unaudited)			(Unaudited)			
Indemnity							
Net investment income	\$4	\$4	0.5 %	\$11	\$12	(10.2 %)	
Net realized gains on investments	1	2	(77.8 %)	1	4	(79.8 %)	
Net impairment losses recognized in earnings	0	0	NM	0	0	NM	
Equity in earnings of limited partnerships	5	6	(6.0 %)	13	10	32.4 %	
Net revenue from investment operations – Indemnity	\$10	\$12	(21.4 %)	\$25	\$26	(6.1 %)	
Exchange							
Net investment income	\$107	\$104	2.4 %	\$313	\$322	(2.8 %)	
Net realized gains on investments	190	167	14.6 %	500	354	41.4 %	
Net impairment losses recognized in earnings	(9 )	0	NM	(10 )	0	NM	
Equity in earnings of limited partnerships	32	35	(9.1 %)	99	89	11.0 %	
Net revenue from investment operations – Exchange <sup>(1)</sup>	\$320	\$306	4.9 %	\$902	\$765	18.0 %	

NM = not meaningful

(1) The Exchange's investment results for the third quarter of 2013 and 2012 include net investment revenues from EFL's operations of \$26 million and \$25 million, respectively. The Exchange's investment results for the first nine months of 2013 and 2012 both include net investment revenues from EFL's operations of \$78 million and \$77 million, respectively.

## Net investment income

Net investment income primarily includes interest and dividends on our fixed maturity and equity security portfolios net of investment expenses. Indemnity's net investment income was unchanged in the third quarter of 2013, compared to the third quarter of 2012, while the Exchange's net investment income increased \$3 million. Indemnity's net investment income decreased \$1 million for the nine months ended September 30, 2013, compared to the nine months ended September 30, 2012, while the Exchange's net investment income decreased \$9 million. The increase in net investment income during the third quarter of 2013 for the Exchange was due to higher invested balances, which more than offset lower investment yields. The decrease in net investment income for Indemnity for the nine months ended September 30, 2013 was primarily due to lower invested balances, while the decrease for the Exchange was due to lower investment yields, which more than offset higher invested balances.

## Net realized gains on investments

Net realized gains and losses on investments include the changes in fair value of common stocks designated as trading securities, and gains and losses resulting from the actual sales of all security categories. Indemnity generated net realized gains of \$1 million in the third quarter of 2013, compared to gains of \$2 million in the third quarter of 2012, while the Exchange generated net realized gains of \$190 million, compared to gains of \$167 million. Indemnity generated net realized gains of \$1 million for the nine months ended September 30, 2013, compared to gains of \$4 million for the nine months ended September 30, 2012, while the Exchange generated net realized gains of \$500

million, compared to gains of \$354 million.

Indemnity recorded no changes in the fair value of common stocks in the third quarter or the nine months ended September 30, 2013, due to the sale of its common stock portfolio classified as trading securities in the fourth quarter of 2012. Net realized gains for Indemnity in the third quarter and nine months ended September 30, 2012 primarily represented increases in the fair value of common stocks. Net realized gains for the Exchange increased in the third quarter of 2013, and nine months ended September 30, 2013, primarily due to larger realized gains from sales of common stock.

#### Net impairment losses recognized in earnings

Net impairment losses recorded in earnings for Indemnity were \$0.2 million in the third quarter of 2013, and \$0.3 million for the nine months ended September 30, 2013, compared to no net impairment losses for the third quarter and nine months ended September 30, 2012. Net impairment losses for the Exchange were \$9 million for the third quarter of 2013, and \$10 million for the nine months ended September 30, 2013, compared to no net impairment losses for the third quarter of 2012, and \$0.1 million for the nine months ended September 30, 2012. The increase in impairments for the Exchange was primarily due to an equity security in an unrealized loss position that we intend to sell prior to an expected recovery of fair value to cost. As a result, an impairment charge was recorded in earnings during the third quarter of 2013.



Table of Contents

## Equity in earnings of limited partnerships

Indemnity's equity in earnings of limited partnerships decreased \$1 million in the third quarter of 2013, compared to the third quarter of 2012, while the Exchange's equity in earnings of limited partnerships decreased \$3 million. Indemnity's equity in earnings of limited partnerships increased \$3 million for the nine months ended September 30, 2013, compared to the nine months ended September 30, 2012, while the Exchange's equity in earnings of limited partnerships increased \$10 million. The decrease in earnings for Indemnity and the Exchange during the third quarter of 2013 was primarily due to lower earnings from private equity investments. For the nine months ended September 30, 2013, the increase in earnings for Indemnity and the Exchange was primarily due to higher earnings from real estate investments.

A breakdown of our net realized gains (losses) on investments is as follows:

(in millions)	Erie Insurance Group			
	Three months ended September 30, 2013		Nine months ended September 30, 2012	
	(Unaudited)		(Unaudited)	
Indemnity				
Securities sold:				
Fixed maturities	\$1	\$0	\$1	\$0
Equity securities	0	0	0	0
Common stock equity securities	0	0	0	1
Common stock increases in fair value <sup>(1)</sup>	0	2	0	3
Total net realized gains – Indemnity <sup>(2)</sup>	\$1	\$2	\$1	\$4
Exchange				
Securities sold:				
Fixed maturities	\$(16	) \$16	\$1	\$35
Equity securities	(9	) 0	(5	) 3
Common stock equity securities	82	13	223	65
Common stock increases in fair value <sup>(1)</sup>	133	138	281	251
Total net realized gains – Exchange <sup>(2) (3)</sup>	\$190	\$167	\$500	\$354

(1) The fair value on our common stock portfolio is based upon exchange traded prices provided by a nationally recognized pricing service.

(2) See Item 1. "Financial Statements – Note 7. Investments," contained within this report for additional disclosures regarding net realized gains (losses) on investments.

(3) The Exchange's results for both the third quarters of 2013 and 2012 include net realized gains from EFL's operations of \$2 million. The Exchange's results for the first nine months of 2013 and 2012 include net realized gains from EFL's operations of \$8 million and \$6 million, respectively.

The components of equity in earnings (losses) of limited partnerships are as follows:

(in millions)	Erie Insurance Group			
	Three months ended September 30, 2013		Nine months ended September 30, 2012	
	(Unaudited)		(Unaudited)	
Indemnity				

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Private equity	\$0	\$2	\$2	\$4
Mezzanine debt	2	1	3	4
Real estate	3	3	8	2
Total equity in earnings of limited partnerships – Indemnity	\$5	\$6	\$13	\$10
Exchange				
Private equity	\$14	\$16	\$46	\$44
Mezzanine debt	7	7	19	24
Real estate	11	12	34	21
Total equity in earnings of limited partnerships – Exchange <sup>(1)</sup>	\$32	\$35	\$99	\$89

The Exchange's results for the third quarter of 2013 and 2012 include equity in earnings of limited partnerships from EFL's operations of \$0.1 million and \$0.2 million, respectively. The Exchange's results for the first nine months of 2013 and 2012 include equity in earnings of limited partnerships from EFL's operations of \$1 million and no earnings, respectively.

Table of Contents

Limited partnership earnings pertain to investments in U.S. and foreign private equity, mezzanine debt and real estate partnerships. Valuation adjustments are recorded to reflect the changes in fair value of the underlying investments held by the limited partnerships. These adjustments are recorded as a component of equity in earnings of limited partnerships in the Consolidated Statements of Operations.

Limited partnership earnings tend to be cyclical based upon market conditions, the age of the partnership, and the nature of the investments. Generally, limited partnership earnings are recorded on a quarter lag from financial statements we receive from our general partners. As a consequence, earnings from limited partnerships reported at September 30, 2013 reflect investment valuation changes resulting from the financial markets and the economy in the second quarter of 2013.

Table of Contents

## FINANCIAL CONDITION

## Investments

We generate revenues from our fixed maturity, equity security and limited partnership investment portfolios to support our underwriting business. The Indemnity and Exchange portfolios are managed with the objective of maximizing after-tax returns on a risk-adjusted basis, while the EFL portfolio is managed to be closely aligned to its liabilities and to maintain a sufficient yield to meet profitability targets. Management actively evaluates the portfolios for impairments. We record impairment writedowns on investments in instances where the fair value of the investment is substantially below cost, and we conclude that the decline in fair value is other-than-temporary, which includes consideration for intent to sell.

## Distribution of investments

(in millions)	Erie Insurance Group					
	Carrying value at September 30, 2013 (Unaudited)	% to total		Carrying value at December 31, 2012	% to total	
Indemnity						
Fixed maturities	\$499	71	%	\$452	66	%
Equity securities:						
Preferred stock	23	3		29	4	
Common stock	25	4		26	4	
Limited partnerships:						
Private equity	65	9		73	11	
Mezzanine debt	22	3		27	4	
Real estate	71	10		80	11	
Real estate mortgage loans	1	0		1	0	
Total investments – Indemnity	\$706	100	%	\$688	100	%
Exchange						
Fixed maturities	\$7,921	62	%	\$7,707	64	%
Equity securities:						
Preferred stock	611	5		631	5	
Common stock	3,183	25		2,731	22	
Limited partnerships:						
Private equity	477	4		482	4	
Mezzanine debt	178	1		196	2	
Real estate	324	3		359	3	
Life policy loans	17	0		16	0	
Real estate mortgage loans	3	0		4	0	
Total investments – Exchange	\$12,714	100	%	\$12,126	100	%
Total investments – Erie Insurance Group	\$13,420			\$12,814		

We continually review our investment portfolio to evaluate positions that might incur other-than-temporary declines in value. For all investment holdings, general economic conditions and/or conditions specifically affecting the underlying issuer or its industry, including downgrades by the major rating agencies, are considered in evaluating impairment in value. In addition to specific factors, other factors considered in our review of investment valuation are the length of time the fair value is below cost and the amount the fair value is below cost.

We individually analyze all positions with emphasis on those that have, in management's opinion, declined significantly below cost. In compliance with impairment guidance for debt securities, we perform further analysis to determine if a credit-related impairment has occurred. Some of the factors considered in determining whether a debt security is credit impaired include potential for the default of interest and/or principal, level of subordination, collateral of the issue, compliance with financial covenants, credit ratings and industry conditions. We have the intent to sell all credit-impaired debt securities, therefore the entire amount of the impairment charges are included in earnings and no credit impairments are recorded in other comprehensive income. For available-for-sale equity securities, a charge is recorded in the Consolidated Statements of Operations for positions that have experienced other-than-temporary impairments due to credit quality or other factors. (See the "Investment Operations" section herein for further information.) Management believes its investment valuation philosophy and accounting practices result in appropriate and timely measurement of value and recognition of impairment.

Table of Contents

## Fixed maturities

Under our investment strategy, we maintain a fixed maturity portfolio that is of high quality and well diversified within each market sector. This investment strategy also achieves a balanced maturity schedule. Our fixed maturity portfolio is managed with the goal of achieving reasonable returns while limiting exposure to risk. Our municipal bond portfolio accounts for \$219 million, or 44%, of the total fixed maturity portfolio for Indemnity and \$1.4 billion, or 18%, of the fixed maturity portfolio for the Exchange at September 30, 2013. The overall credit rating of the municipal portfolio without consideration of the underlying insurance is AA.

Fixed maturities classified as available-for-sale are carried at fair value with unrealized gains and losses, net of deferred taxes, included in shareholders' equity. Indemnity's net unrealized gains on fixed maturities, net of deferred taxes, amounted to \$6 million at September 30, 2013, compared to \$10 million at December 31, 2012. At September 30, 2013, the Exchange had net unrealized gains on fixed maturities of \$247 million, compared to \$449 million at December 31, 2012.

The following table presents a breakdown of the fair value of our fixed maturities portfolio by sector and rating for Indemnity and the Exchange, respectively:

(in millions)	Erie Insurance Group <sup>(1)</sup> At September 30, 2013 (Unaudited)					Fair value
	AAA	AA	A	BBB	Non- investment grade	
Industry Sector						
Indemnity						
Basic materials	\$0	\$0	\$5	\$11	\$0	\$16
Communications	0	0	10	15	0	25
Consumer	0	0	11	16	0	27
Energy	0	5	10	15	0	30
Financial	0	34	64	51	0	149
Government-municipal	91	88	35	5	0	219
Industrial	0	0	1	6	0	7
Structured securities <sup>(2)</sup>	0	0	0	1	0	1
Technology	0	0	0	9	0	9
Utilities	0	0	0	16	0	16
Total – Indemnity	\$91	\$127	\$136	\$145	\$0	\$499
Exchange						
Basic materials	\$0	\$0	\$47	\$176	\$15	\$238
Communications	0	0	155	376	14	545
Consumer	0	26	300	619	15	960
Diversified	0	0	15	0	0	15
Energy	15	55	150	411	13	644
Financial	1	148	1,119	1,163	121	2,552
Foreign government	0	10	5	0	0	15
Government-municipal	392	823	169	47	0	1,431
Government sponsored entity	0	38	0	0	0	38
Industrial	0	10	55	250	15	330
Structured securities <sup>(2)</sup>	36	230	45	18	3	332
Technology	0	28	55	88	0	171
U.S. Treasury	0	135	0	0	0	135
Utilities	0	3	100	377	35	515

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Total – Exchange	\$444	\$1,506	\$2,215	\$3,525	\$231	\$7,921
------------------	-------	---------	---------	---------	-------	---------

(1) Ratings are supplied by S&P, Moody's, and Fitch. The table is based upon the lowest rating for each security.

(2) Structured securities include asset-backed securities, collateral, lease and debt obligations, commercial mortgage-backed securities and residential mortgage-backed securities.

59

---

Table of Contents

## Equity securities

Our equity securities consist of common stock and nonredeemable preferred stock. Investment characteristics of common stock and non-redeemable preferred stock differ from one another. Our nonredeemable preferred stock portfolio provides a source of current income that is competitive with investment-grade bonds.

The following table presents an analysis of the fair value of our preferred and common stock securities by sector for Indemnity and Exchange, respectively:

(in millions)	Erie Insurance Group			
	Fair value at:		December 31, 2012	
	September 30, 2013			
	(Unaudited)			
Industry sector	Preferred stock	Common stock	Preferred stock	Common stock
Indemnity				
Communications	\$1	\$0	\$1	\$0
Diversified	3	0	3	0
Financial	14	0	15	0
Funds <sup>(1)</sup>	0	25	0	26
Utilities	5	0	10	0
Total – Indemnity	\$23	\$25	\$29	\$26
Exchange				
Basic materials	\$0	\$79	\$0	\$94
Communications	10	318	10	190
Consumer	6	912	5	765
Diversified	2	13	2	21
Energy	0	196	0	177
Financial	495	475	495	423
Funds <sup>(1)</sup>	0	495	0	436
Government	1	0	1	0
Industrial	0	418	0	390
Technology	0	220	0	197
Utilities	97	57	118	38
Total – Exchange	\$611	\$3,183	\$631	\$2,731

Includes certain exchange traded funds with underlying holdings of fixed maturity securities totaling \$25 million for Indemnity and \$238 million for the Exchange at September 30, 2013, and \$26 million for Indemnity and \$314 (1) million for the Exchange at December 31, 2012. These securities meet the criteria of a common stock under U.S. GAAP, and are included on the balance sheet as available-for-sale equity securities. Remaining common stock investments are classified as trading securities.

Equity securities classified as available-for-sale include preferred and certain common stock securities, and are carried at fair value on the Consolidated Statements of Financial Position with all changes in unrealized gains and losses reflected in other comprehensive income. The unrealized loss on equity securities classified as available-for-sale, net of deferred taxes, for Indemnity was less than \$0.1 million at September 30, 2013, compared to an unrealized gain of \$1 million at December 31, 2012. The net unrealized gain on equity securities classified as available-for-sale for the Exchange was \$26 million at September 30, 2013, compared to an unrealized gain of \$48 million at December 31, 2012.



Our common stocks classified as trading securities are measured at fair value with all changes in unrealized gains and losses reflected in the Consolidated Statements of Operations.

60

---

Table of Contents

## Limited partnerships

In the third quarter of 2013, investments in limited partnerships decreased modestly for Indemnity and the Exchange from the investment levels at December 31, 2012. Changes in partnership values are a function of contributions and distributions, adjusted for market value changes in the underlying investments. The decrease in limited partnership investments was due to net distributions received from the partnerships which were partially offset by partnership earnings. The results from our limited partnerships are based upon financial statements received from our general partners, which are generally received on a quarter lag. As a result, the market values and earnings recorded during the third quarter of 2013 reflect the partnership activity experienced in the second quarter of 2013.

The components of limited partnership investments are as follows:

(in millions)	Erie Insurance Group	
	At September 30, 2013 (Unaudited)	At December 31, 2012
Indemnity		
Private equity	\$65	\$73
Mezzanine debt	22	27
Real estate	71	80
Total limited partnerships – Indemnity	\$158	\$180
Exchange		
Private equity	\$477	\$482
Mezzanine debt	178	196
Real estate	324	359
Total limited partnerships – Exchange	\$979	\$1,037

Table of Contents

## Liabilities

## Property and casualty losses and loss expense reserves

Loss reserves are established to account for the estimated ultimate costs of losses and loss expenses for claims that have been reported but not yet settled and claims that have been incurred but not reported. While we exercise professional diligence to establish reserves at the end of each period that are fully reflective of the ultimate value of all claims incurred, these reserves are, by their nature, only estimates and cannot be established with absolute certainty.

The factors which may potentially cause the greatest variation between current reserve estimates and the actual future paid amounts include unforeseen changes in statutory or case law altering the amounts to be paid on existing claim obligations, new medical procedures and/or drugs with costs significantly different from those seen in the past, and claims patterns on current business that differ significantly from historical claims patterns.

Losses and loss expense reserves are presented on the Consolidated Statements of Financial Position on a gross basis. The following table represents the direct and assumed losses and loss expense reserves by major line of business for our property and casualty insurance operations. The reinsurance recoverable amount represents the related ceded amounts which results in the net liability attributable to the Property and Casualty Group.

(in millions)	Property and Casualty Group	
	At September 30, 2013	At December 31, 2012
	(Unaudited)	
Gross reserve liability <sup>(1)</sup> :		
Personal auto	\$1,172	\$1,169
Automobile massive injury	351	351
Homeowners	299	299
Workers compensation	557	512
Workers compensation massive injury	105	99
Commercial auto	365	340
Commercial multi-peril	587	557
All other lines of business	173	166
Assumed reinsurance	103	105
Gross reserves	3,712	3,598
Reinsurance recoverable	159	154
Net reserve liability — Exchange	\$3,553	\$3,444

Loss reserves are set at full expected cost, except for workers compensation loss reserves which have been (1) discounted using an interest rate of 2.5%. This discounting reduced unpaid losses and loss expenses by \$89 million at September 30, 2013 and \$85 million at December 31, 2012.

The reserves that have the greatest potential for variation are the massive injury lifetime medical claim reserves. The Property and Casualty Group is currently reserving for 268 claimants requiring lifetime medical care, of which 112 involve massive injuries. The reserve carried by the Property and Casualty Group for the massive injury claimants, which includes automobile massive injury and workers compensation massive injury reserves, totaled \$307 million at September 30, 2013, which is net of \$149 million of anticipated reinsurance recoverables, compared to \$305 million at December 31, 2012, which is net of \$145 million of anticipated reinsurance recoverables.

## Life insurance reserves

EFL's primary commitment is its obligation to pay future policy benefits under the terms of its life insurance and annuity contracts. To meet these future obligations, EFL establishes life insurance reserves based upon the type of policy, the age, gender and risk class of the insured and the number of years the policy has been in force. EFL also establishes annuity and universal life reserves based upon the amount of policyholder deposits (less applicable insurance and expense charges) plus interest earned on those deposits. Life insurance and annuity reserves are supported primarily by EFL's long-term, fixed income investments as the underlying policy reserves are generally also of a long-term nature.

Table of Contents

## IMPACT OF INFLATION

Property and casualty insurance premiums are established before losses occur and before loss expenses are incurred, and therefore, before the extent to which inflation may impact such costs is known. Consequently, in establishing premium rates, we attempt to anticipate the potential impact of inflation, including medical cost inflation, construction and auto repair cost inflation and tort issues. Medical costs are a broad element of inflation that impacts personal and commercial auto, general liability, workers compensation and commercial multi-peril lines of insurance written by the Property and Casualty Group. Inflation assumptions take the form of explicit numerical values in the survival ratio, individual claim, and massive injury lifetime medical reserving methods. Inflation assumptions are implicitly derived through the selection of applicable loss development patterns for all other reserving methods. Occasionally, unusual aberrations in loss development patterns are caused by external and internal factors such as changes in claim reporting, settlement patterns, unusually large losses, process changes, legal or regulatory changes, and other influences. In these instances, analyses of alternate development factor selections are performed to evaluate the effect of these factors and actuarial judgment is applied to make appropriate assumptions needed to develop a best estimate of ultimate losses.

## LIQUIDITY AND CAPITAL RESOURCES

## Sources and Uses of Cash

Liquidity is a measure of a company's ability to generate sufficient cash flows to meet the short- and long-term cash requirements of its business operations and growth needs. Our liquidity requirements have been met primarily by funds generated from premiums collected and income from investments. Our insurance operations provide liquidity in that premiums are collected in advance of paying losses under the policies purchased with those premiums. Cash outflows for the property and casualty insurance business are generally variable since settlement dates for liabilities for unpaid losses and the potential for large losses, whether individual or in the aggregate, cannot be predicted with absolute certainty. Accordingly, after satisfying our operating cash requirements, excess cash flows are used to build our investment operation's portfolios in order to increase future investment income, which then may be used as a source of liquidity if cash from our insurance operations would not be sufficient to meet our obligations. Cash provided from these sources is used primarily to fund losses and policyholder benefits, fund the costs of our management operations including commissions, salaries and wages, pension plans, share repurchases, dividends to shareholders and the purchase and development of information technology. We expect that our operating cash needs will be met by funds generated from operations.

Volatility in the financial markets presents challenges to us as we do occasionally access our investment portfolio as a source of cash. Some of our fixed income investments, despite being publicly traded, are illiquid. Volatility in these markets could impair our ability to sell certain of our fixed income securities or cause such securities to sell at deep discounts. Additionally, our limited partnership investments are significantly less liquid. We believe we have sufficient liquidity to meet our needs from other sources even if market volatility persists throughout 2013.

## Cash flow activities — Erie Insurance Group

The following table provides condensed consolidated cash flow information for the nine months ended September 30:

(in millions)	Erie Insurance Group	
	2013	2012
Net cash provided by operating activities	\$689	\$365
Net cash used in investing activities	(498	) (34
Net cash used in financing activities	(56	) (112
Net increase in cash and cash equivalents	\$135	\$219

Net cash provided by operating activities totaled \$689 million and \$365 million for the first nine months of 2013 and 2012, respectively. Increased cash from operating activities for the first nine months of 2013 was driven primarily by an increase in premiums collected by the Exchange driven by the increase in premiums written, a decrease in income taxes paid, an increase in limited partnership distributions received, and a slight decrease in losses and loss expenses paid. Offsetting this increase in cash somewhat was an increase in other underwriting and acquisition costs paid, and a slight decline in net investment income received, compared to the first nine months of 2012.

At September 30, 2013, we recorded a net deferred tax asset of \$42 million attributable to Indemnity and a net deferred tax liability of \$368 million attributable to the Exchange. There was no deferred tax valuation allowance recorded at

Table of Contents

September 30, 2013. Our capital gain and loss strategies take into consideration our ability to offset gains and losses in future periods, carry-back of capital loss opportunities to the three preceding years, and capital loss carry-forward opportunities to apply against future capital gains over the next five years.

Net cash used in investing activities totaled \$498 million and \$34 million for the first nine months of 2013 and 2012, respectively. In the first nine months of 2013, investing activities primarily included increased cash used to purchase certain fixed maturity securities and common stocks, offset by increased cash generated from the sale of other common stocks and fixed maturity securities, compared to the first nine months of 2012. At September 30, 2013, we had contractual commitments to invest up to \$418 million related to our limited partnership investments to be funded as required by the partnerships' agreements. Of this amount, the total remaining commitment to fund limited partnerships that invest in private equity securities was \$151 million, mezzanine debt securities was \$174 million, and real estate activities was \$93 million.

For a discussion of net cash used in financing activities, see the following "Cash flow activities — Indemnity," for the primary drivers of the financing cash flows related to the Indemnity shareholder interest.

## Cash flow activities — Indemnity

The following table is a summary of cash flows for Indemnity for the nine months ended September 30:

(in millions)	Indemnity Shareholder Interest	
	2013	2012
Net cash provided by operating activities	\$132	\$144
Net cash used in investing activities	(33)	(8)
Net cash used in financing activities	(78)	(135)
Net increase in cash and cash equivalents	\$21	\$1

See Item 1. "Financial Statements - Note 15. Indemnity Supplemental Information," contained within this report for more detail on Indemnity's cash flows.

Net cash provided by Indemnity's operating activities totaled \$132 million for the first nine months of 2013, compared to \$144 million for the first nine months of 2012. The slight decrease in cash from operating activities for the first nine months of 2013 was primarily due to increased cash used for commissions paid to agents, general operating expenses, salaries and wages, and income taxes. Offsetting this decrease in cash were increases in management fee revenue and limited partnership distributions received compared to the first nine months of 2012. Management fee revenues were higher reflecting the increase in the premiums written or assumed by the Exchange. Cash paid for agent commissions and bonuses increased to \$521 million in the first nine months of 2013, compared to \$470 million for the first nine months of 2012, as a result of an increase in cash paid for ordinary commissions. Indemnity made a \$17 million contribution to its pension plan in the first quarter of 2013, compared to \$16 million in the first quarter of 2012. Indemnity's policy for funding its pension plan is generally to contribute an amount equal to the greater of the IRS minimum required contribution or the target normal cost for the year plus interest to the date the contribution is made. Indemnity is generally reimbursed approximately 57% of the net periodic benefit cost of the pension plan from its affiliates, which represents pension benefits for Indemnity employees performing claims and life functions.

At September 30, 2013, Indemnity recorded a net deferred tax asset of \$42 million. There was no deferred tax valuation allowance recorded at September 30, 2013.

Net cash used by Indemnity's investing activities totaled \$33 million for the first nine months of 2013, compared to \$8 million for the first nine months of 2012. Indemnity's first nine months of 2013 investing activities primarily included

decreased cash generated from the sales of fixed maturity securities compared to the first nine months of 2012. Also impacting Indemnity's future investing activities are limited partnership commitments, which totaled \$30 million at September 30, 2013, and will be funded as required by the partnerships' agreements. Of this amount, the total remaining commitment to fund limited partnerships that invest in private equity securities was \$14 million, mezzanine debt securities was \$10 million, and real estate activities was \$6 million.

Net cash used in Indemnity's financing activities totaled \$78 million for the first nine months of 2013, compared to \$135 million for the first nine months of 2012. The decrease in cash used in financing activities for the first nine months of 2013 was driven by a decrease in the cash outlay for share repurchases and a decrease in dividends paid to shareholders. Indemnity repurchased 69,734 shares of its Class A nonvoting common stock in conjunction with its stock repurchase program at a total cost of \$5.2 million, based upon settlement date, in the third quarter of 2013. During the first nine months of 2013, shares



## Table of Contents

repurchased under this program totaled 296,896 at a total cost of \$21.5 million. In the first nine months of 2012, shares repurchased under this program totaled 754,425 at a total cost of \$54.9 million. In October 2011, our Board of Directors approved a continuation of the current stock repurchase program for a total of \$150 million with no time limitation. This repurchase authority includes, and is not in addition to, any unspent amounts remaining under the prior authorization. Indemnity had approximately \$47 million of repurchase authority remaining under this program at September 30, 2013, based upon trade date.

Additionally, in January and June 2013, Indemnity purchased 444 and 3,033 shares, respectively, of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$30,927, or \$69.65 per share, and \$224,527 or \$74.03 per share, to settle payments due to retired executives under our long-term incentive plan. These shares were delivered to the plan participant in January and July 2013, respectively. In January and June 2012, Indemnity purchased 669 and 1,134 shares, respectively, of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$50,724, or \$75.82 per share, and \$79,125, or \$69.78 per share, respectively, to settle payments due to two retired senior vice presidents under our long-term incentive plan. These shares were delivered to the plan participants in January and June 2012, respectively.

Dividends paid to shareholders totaled \$56 million for the first nine months of 2013, compared to \$80 million for the first nine months of 2012. Normally, a regular quarterly dividend is declared by the Board at its December meeting of the previous year and paid in January, as in the first nine months of 2012. In the first nine months of 2013 however, the payment of the regular dividend normally made in January was accelerated and paid in December 2012 due to the potential significant increases in tax rates on 2013 dividend income pending at the time of declaration. Indemnity increased both its Class A and Class B shareholder quarterly dividends by 7.2% for 2013, compared to 2012. There are no regulatory restrictions on the payment of dividends to Indemnity's shareholders.

### Capital Outlook

We regularly prepare forecasts evaluating the current and future cash requirements of Indemnity and the Exchange for both normal and extreme risk events. Should an extreme risk event result in a cash requirement exceeding normal cash flows, we have the ability to meet our future funding requirements through various alternatives available to us.

### Indemnity

Outside of Indemnity's normal operating and investing cash activities, future funding requirements could be met through: 1) Indemnity's cash and cash equivalents, which total approximately \$33 million at September 30, 2013, 2) a \$100 million bank revolving line of credit held by Indemnity, and 3) liquidation of assets held in Indemnity's investment portfolio, including common stock, preferred stock and investment grade bonds which totaled approximately \$436 million at September 30, 2013. Volatility in the financial markets could impair Indemnity's ability to sell certain of its fixed income securities or cause such securities to sell at deep discounts. Additionally, Indemnity has the ability to curtail or modify discretionary cash outlays such as those related to shareholder dividends and share repurchase activities.

As of September 30, 2013, Indemnity has access to a \$100 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on November 3, 2016. As of September 30, 2013, a total of \$98.2 million remains available under the facility due to \$1.8 million outstanding letters of credit, which reduce the availability for letters of credit to \$23.2 million. Indemnity had no borrowings outstanding on its line of credit as of September 30, 2013. Bonds with a fair value of \$111 million were pledged as collateral on the line at September 30, 2013. These securities have no trading restrictions. The bank requires compliance with certain covenants, which include minimum net worth and leverage ratios. Indemnity was in compliance with its bank covenants at September 30, 2013. On October 25, 2013, Indemnity amended its revolving credit facility to extend the maturity date to November 3, 2018, lower the borrowing costs, and eliminate the minimum net worth financial covenant.

#### Exchange

Outside of the Exchange's normal operating and investing cash activities, future funding requirements could be met through: 1) the Exchange's cash and cash equivalents, which total approximately \$502 million at September 30, 2013, 2) a \$300 million bank revolving line of credit held by the Exchange, and 3) liquidation of assets held in the Exchange's investment portfolio, including common stock, preferred stock and investment grade bonds which totaled approximately \$11.2 billion at September 30, 2013. Volatility in the financial markets could impair the Exchange's ability to sell certain of its fixed income securities or cause such securities to sell at deep discounts.

As of September 30, 2013, the Exchange has access to a \$300 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on October 28, 2016. As of September 30, 2013, a total of \$298.9 million remains available under the facility due to \$1.1 million outstanding letters of credit, which reduce the availability for letters of credit to \$23.9 million.

## Table of Contents

The Exchange had no borrowings outstanding on its line of credit as of September 30, 2013. Bonds with a fair value of \$332 million were pledged as collateral on the line at September 30, 2013. These securities have no trading restrictions. The bank requires compliance with certain covenants, which include statutory surplus and risk based capital ratios. The Exchange was in compliance with its bank covenants at September 30, 2013. On October 25, 2013, the Exchange entered into a second amended and restated credit agreement to extend the maturity date to October 25, 2018, lower the borrowing costs, and eliminate the minimum statutory surplus covenant.

Indemnity has no rights to the assets, capital, or line of credit of the Exchange and, conversely, the Exchange has no rights to the assets, capital, or line of credit of Indemnity. We believe we have the funding sources available to us to support our cash flow requirements in 2013.

### Off-Balance Sheet Arrangements

Off-balance sheet arrangements include those with unconsolidated entities that may have a material current or future effect on our financial condition or results of operations, including material variable interests in unconsolidated entities that conduct certain activities. We have no material off-balance sheet obligations or guarantees, other than limited partnership investment commitments.

### Surplus Notes

Indemnity holds a surplus note for \$25 million from EFL that is payable on demand on or after December 31, 2018; however, no principal or interest payments may be made without prior approval of the Pennsylvania Insurance Commissioner. Interest payments are scheduled to be paid semi-annually. For the nine months ended September 30, 2013 and 2012, Indemnity recognized interest income on the note of \$1.3 million.

The Exchange holds a surplus note for \$20 million from EFL that is payable on demand on or after December 31, 2025; however, no principal or interest payments may be made without prior approval of the Pennsylvania Insurance Commissioner. Interest payments are scheduled to be paid semi-annually. For the nine months ended September 30, 2013 and 2012, the Exchange recognized interest income on the note of \$0.9 million.

## CRITICAL ACCOUNTING ESTIMATES

We make estimates and assumptions that have a significant effect on the amounts and disclosures reported in the financial statements. The most significant estimates relate to the property and casualty insurance losses and loss expense reserves, life insurance and annuity policy reserves, investment valuation, deferred acquisition costs related to life insurance and investment-type contracts, deferred taxes and retirement benefit plans for employees. While management believes its estimates are appropriate, the ultimate amounts may differ from estimates provided. Our most critical accounting estimates are described in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," for the year ended December 31, 2012 of our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on February 26, 2013. See Item 1. "Financial Statements - Note 6. Fair Value," contained within this report for additional information on our valuation of investments.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is primarily related to fluctuations in prices and interest rates. Quantitative and qualitative disclosures about market risk resulting from changes in prices and interest rates for the year ended December 31, 2012 are included in Item 7A. “Quantitative and Qualitative Disclosures About Market Risk,” of our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on February 26, 2013.

There have been no material changes that impact our portfolio or reshape our periodic investment reviews of asset allocations during the nine months ended September 30, 2013. For a recent discussion of conditions surrounding our investment portfolio, see the “Operating Overview,” “Investment Operations,” and “Financial Condition, Investments” discussions contained in Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” within this report.

ITEM 4. CONTROLS AND PROCEDURES

We carried out an evaluation, with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

Our management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, any change in our internal control over financial reporting and determined there has been no change in our internal control over financial reporting during the nine months ended September 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

State Court Lawsuit Against Erie Indemnity Company

Erie Indemnity Company (“Indemnity”) was named as a defendant in a complaint filed on August 1, 2012 by alleged subscribers of the Erie Insurance Exchange (the “Exchange”) in the Court of Common Pleas Civil Division of Fayette County, Pennsylvania captioned Erie Insurance Exchange, an unincorporated association, by Joseph S. Sullivan and Anita Sullivan, Patricia R. Beltz, and Jenna L. DeBord, trustees ad litem v. Erie Indemnity Co. (the “Sullivan” lawsuit).

As subsequently amended, the complaint alleges that, beginning on September 1, 1997, Indemnity retained “Service Charges” (installment fees) and, beginning in 2008, retained “Added Service Charges” (late fees and policy reinstatement charges) on policies written by the Exchange and its insurance subsidiaries, which allegedly should have been paid to the Exchange, in the amount of approximately \$308 million. In addition to their claim for monetary relief on behalf of the Exchange, the plaintiffs seek an accounting of all so-called intercompany transactions between Indemnity and the Exchange from 1996 to date. Plaintiffs allege that Indemnity breached its contractual, fiduciary, and equitable duties by retaining Service Charges and Added Service Charges that should have been retained by the Exchange. Plaintiffs bring these same claims under three separate derivative-type theories. First, plaintiffs purport to bring suit as members of the Exchange on behalf of the Exchange. Second, plaintiffs purport to bring suit as trustees ad litem on behalf of the Exchange. Third, plaintiffs purport to bring suit on behalf of the Exchange pursuant to Rule 1506 of the Pennsylvania Rules of Civil Procedure, which allows shareholders to bring suit derivatively on behalf of a corporation or similar entity.

Indemnity removed the case from state court to the United States District Court for the Western District of Pennsylvania on the basis that it was a class action subject to removal under the Federal Class Action Fairness Act. In October 2012, the federal court remanded the case to state court. Indemnity appealed the remand order, and the United States Court of Appeals for the Third Circuit heard the appeal in March 2013. In June 2013, the Third Circuit issued a ruling affirming the remand to state court. Indemnity filed a Petition for Panel Rehearing or Rehearing En Banc in July 2013. The Third Circuit denied the Petition for Panel Rehearing or Rehearing En Banc in July 2013.

The state court entered an order in February 2013 staying all proceedings in the Sullivan case pending the outcome of the appeal to the Third Circuit. In July, Plaintiffs filed a Petition in state court seeking to lift the stay. The stay has been lifted.

Indemnity filed a motion in the state court in November 2012 seeking dismissal of the lawsuit. A hearing on that motion was held by the state court in February 2013. Additional briefing was filed and another hearing was held on the motion in October 2013. A decision has not yet been rendered.

The Sullivan lawsuit is in its early stages. Indemnity believes that it has meritorious legal and factual defenses and intends to vigorously defend against all allegations and requests for relief in the lawsuit.

Federal Court Lawsuit Against Directors

On February 6, 2013, a lawsuit was filed in the United States District Court for the Western District of Pennsylvania, captioned Erie Insurance Exchange, an unincorporated association, by members Patricia R. Beltz, Joseph S. Sullivan and Anita Sullivan, and Patricia R. Beltz, on behalf of herself and others similarly situate v. Richard L. Stover; J. Ralph Borneman, Jr; Terrence W. Cavanaugh; Jonathan Hirt Hagen; Susan Hirt Hagen; Thomas B. Hagen; C. Scott Hartz; Claude C. Lilly, III; Lucian L. Morrison; Thomas W. Palmer; Martin P. Sheffield; Elizabeth H. Vorscheck; and Robert C. Wilburn (the “Beltz” lawsuit), by alleged policyholders of the Exchange who are also the plaintiffs in the Sullivan lawsuit. The individuals named as defendants in the Beltz lawsuit are the current Directors of Indemnity.

As subsequently amended, the Beltz lawsuit asserts many of the same allegations and claims for monetary relief as in the Sullivan lawsuit. Plaintiffs purport to sue on behalf of all policyholders of the Exchange, or, alternatively, on behalf of the Exchange itself. Indemnity filed a Motion to Intervene as a Party Defendant in the Beltz lawsuit in July 2013 and the Directors filed a Motion to Dismiss the lawsuit in August 2013. No decisions have yet been rendered on either motion.

The Directors have advised Indemnity that they intend to vigorously defend against the claims in the Beltz lawsuit and they have sought indemnification and advancement of expenses from the Company in connection with the Beltz lawsuit.

Table of Contents

## ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 as filed with the Securities and Exchange Commission on February 26, 2013.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

## Issuer Purchases of Equity Securities

The following table summarizes Indemnity's Class A common stock repurchased each month, based upon trade date, during the quarter ended September 30, 2013:

(dollars in millions, except per share data)	Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Approximate Dollar Value of Shares that May Yet be Purchased Under the Program
	July 1 – 31, 2013	0	\$0.00	0	\$53
	August 1 – 31, 2013	40,799	74.95	40,799	50
	September 1 – 30, 2013	35,264	74.26	35,264	47
	Total	76,063		76,063	

In October 2011, our Board of Directors approved a continuation of the current stock repurchase program, authorizing repurchases for a total of \$150 million with no time limitation. This repurchase authority included, and was not in addition to, any unspent amounts remaining under the prior authorization.

## ITEM 5. OTHER INFORMATION

As discussed in our October 30, 2013 Form 8-K filing with the Securities and Exchange Commission; on October 25, 2013, Indemnity amended its revolving credit facility to extend the maturity date to November 3, 2018, lower the borrowing costs, and eliminate the minimum net worth financial covenant, and the Exchange entered into a second amended and restated credit agreement to extend the maturity date to October 25, 2018, lower the borrowing costs, and eliminate the minimum statutory surplus covenant.

Table of Contents

## ITEM 6. EXHIBITS

Exhibit Number	Description of Exhibit
10.1	Amended and Restated Credit Agreement among JPMorgan Chase Bank, National Association, as Administrative Agent; the Lenders named therein; and Erie Indemnity Company, dated October 25, 2013. Such exhibit is incorporated by reference to the like titled exhibit in the Registrant's Form 8-K that was filed with the Commission on October 30, 2013.
10.2	Second Amended and Restated Credit Agreement among PNC Bank, National Association, as Administrative Agent; the Lenders named therein; and Erie Insurance Exchange, dated October 25, 2013. Such exhibit is incorporated by reference to the like titled exhibit in the Registrant's Form 8-K that was filed with the Commission on October 30, 2013.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

70



Table of Contents

SIGNATURES

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

Erie Indemnity Company  
(Registrant)

Date: October 31, 2013

By: /s/ Terrence W. Cavanaugh  
Terrence W. Cavanaugh, President & CEO

By: /s/ Marcia A. Dall  
Marcia A. Dall, Executive Vice President &  
CFO