

ERIE INDEMNITY CO  
Form 10-Q  
August 01, 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 June 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 46,679,320 at July 19, 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 July 19, 2013.

---

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Consolidated Statements of Operations – Three and six months ended June 30, 2013 and 2012

Consolidated Statements of Comprehensive Income – Three and six months ended June 30, 2013 and 2012

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

Consolidated Statements of Cash Flows – Six months ended June 30, 2013 and 2012

Notes to Consolidated Financial Statements – June 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 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		Six months ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Revenues				
Premiums earned	\$1,215	\$1,109	\$2,390	\$2,196
Net investment income	104	113	207	221
Net realized investment gains (losses)	61	(107)	) 310	189
Net impairment losses recognized in earnings	(1	) 0	(1	) 0
Equity in earnings of limited partnerships	39	37	75	58
Other income	8	8	16	16
Total revenues	1,426	1,160	2,997	2,680
Benefits and expenses				
Insurance losses and loss expenses	861	943	1,703	1,659
Policy acquisition and underwriting expenses	302	287	595	557
Total benefits and expenses	1,163	1,230	2,298	2,216
Income (loss) from operations before income taxes and noncontrolling interest	263	(70)	) 699	464
Provision for income taxes	86	(32)	) 232	148
Net income (loss)	\$177	\$(38)	) \$467	\$316
Less: Net income (loss) attributable to noncontrolling interest in consolidated entity – Exchange	133	(81)	) 386	237
Net income attributable to Indemnity	\$44	\$43	\$81	\$79
Earnings Per Share				
Net income attributable to Indemnity per share				
Class A common stock – basic	\$0.95	\$0.90	\$1.73	\$1.65
Class A common stock – diluted	\$0.84	\$0.80	\$1.54	\$1.47
Class B common stock – basic and diluted	\$142	\$135	\$259	\$249
Weighted average shares outstanding attributable to Indemnity – Basic				
Class A common stock	46,693,333	47,492,305	46,733,925	47,619,852
Class B common stock	2,542	2,544	2,542	2,545
Weighted average shares outstanding attributable to Indemnity – Diluted				
Class A common stock	52,886,259	53,677,848	52,926,851	53,807,795
Class B common stock	2,542	2,544	2,542	2,545

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Dividends declared per share				
Class A common stock	\$0.5925	\$0.5525	\$1.185	\$1.105
Class B common stock	\$88.8750	\$82.8750	\$177.750	\$165.750

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.

3

---

Table of Contents

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

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Net income (loss)	\$177	\$(38	) \$467	\$316
Other comprehensive (loss) income				
Change in unrealized holding (losses) gains on available-for-sale securities, net of tax (benefit) expense of \$(105), \$12, \$(111), and \$53, respectively	(194	) 21	(206	) 98
Reclassification adjustment for gross gains included in net income, net of tax expense of \$2, \$6, \$7, and \$8, respectively	(3	) (9	) (13	) (14
Other comprehensive (loss) income	(197	) 12	(219	) 84
Comprehensive (loss) income	\$(20	) \$(26	) \$248	\$400
Less: Comprehensive (loss) income attributable to noncontrolling interest in consolidated entity – Exchange	(60	) (69	) 172	319
Total comprehensive income – Indemnity	\$40	\$43	\$76	\$81

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)

	June 30, 2013 (Unaudited)	December 31, 2012
Assets		
Investments – Indemnity		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of \$430 and \$437, respectively)	\$438	\$452
Equity securities (cost of \$47 and \$54, respectively)	48	55
Limited partnerships (cost of \$138 and \$151, respectively)	166	180
Other invested assets	1	1
Investments – Exchange		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of \$7,359 and \$7,016, respectively)	7,725	7,707
Equity securities (cost of \$915 and \$871, respectively)	969	945
Trading securities, at fair value (cost of \$2,069 and \$1,910, respectively)	2,724	2,417
Limited partnerships (cost of \$880 and \$913, respectively)	1,011	1,037
Other invested assets	20	20
Total investments	13,102	12,814
Cash and cash equivalents (Exchange portion of \$326 and \$388, respectively)	365	400
Premiums receivable from policyholders – Exchange	1,191	1,062
Reinsurance recoverable – Exchange	174	168
Deferred income taxes – Indemnity	43	37
Deferred acquisition costs – Exchange	553	504
Other assets (Exchange portion of \$336 and \$339, respectively)	451	456
Total assets	\$ 15,879	\$ 15,441
Liabilities and shareholders' equity		
Liabilities		
Indemnity liabilities		
Other liabilities	\$535	\$515
Exchange liabilities		
Losses and loss expense reserves	3,668	3,598
Life policy and deposit contract reserves	1,739	1,708
Unearned premiums	2,553	2,365
Deferred income taxes	312	365
Other liabilities	104	99
Total liabilities	8,911	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; 46,676,287 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	(138	) (133	)
Retained earnings	1,878	1,852	
Total contributed capital and retained earnings	1,758	1,737	
Treasury stock, at cost, 21,622,913 and 21,406,519 shares, respectively	(1,111	) (1,095	)
Total Indemnity shareholders' equity	647	642	
Noncontrolling interest in consolidated entity – Exchange	6,321	6,149	
Total equity	6,968	6,791	
Total liabilities, shareholders' equity and noncontrolling interest	\$15,879	\$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)

	Six months ended		
	June 30,		
	2013	2012	
Cash flows from operating activities			
Premiums collected	\$2,450	\$2,253	
Net investment income received	222	233	
Limited partnership distributions	79	54	
Service agreement fee received	15	15	
Commissions and bonuses paid to agents	(356)	(320)	)
Losses paid	(1,359)	(1,267)	)
Loss expenses paid	(227)	(232)	)
Other underwriting and acquisition costs paid	(345)	(318)	)
Income taxes paid	(149)	(227)	)
Net cash provided by operating activities	330	191	
Cash flows from investing activities			
Purchase of investments:			
Fixed maturities	(1,240)	(983)	)
Preferred stock	(54)	(82)	)
Common stock	(700)	(518)	)
Limited partnerships	(52)	(42)	)
Sales/maturities of investments:			
Fixed maturity sales	330	338	
Fixed maturity calls/maturities	617	567	
Preferred stock	42	67	
Common stock	654	503	
Sale of and returns on limited partnerships	86	112	
Net purchase of property and equipment	(19)	(20)	)
Net collections on agent loans	1	1	
Net cash used in investing activities	(335)	(57)	)
Cash flows from financing activities			
Annuity deposits and interest	47	49	
Annuity surrenders and withdrawals	(39)	(37)	)
Universal life deposits and interest	12	11	
Universal life surrenders	(5)	(5)	)
Purchase of treasury stock	(17)	(44)	)
Dividends paid to shareholders	(28)	(53)	)
Net cash used in financing activities	(30)	(79)	)
Net (decrease) increase in cash and cash equivalents	(35)	55	
Cash and cash equivalents at beginning of period	400	185	
Cash and cash equivalents at end of period	\$365	\$240	

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

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.

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 six months ended June 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.

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.

In the first quarter of 2012, two shares of Class B common stock were converted into 4,800 shares of Class A common stock. See Note 11. "Indemnity Capital Stock".

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 June 30,					
	2013			2012		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per- share amount
Class A – Basic EPS:						
Income available to Class A stockholders	\$44	46,693,333	\$0.95	\$43	47,492,305	\$0.90
Dilutive effect of stock-based awards	0	92,126	—	0	79,943	—
Assumed conversion of Class B shares	0	6,100,800	—	0	6,105,600	—
Class A – Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	\$44	52,886,259	\$0.84	\$43	53,677,848	\$0.80
Class B – Basic and diluted EPS:						
Income available to Class B stockholders	\$0	2,542	\$142	\$0	2,544	\$135

(dollars in millions, except per share data)	Indemnity Shareholder Interest					
	Six months ended June 30,					
	2013			2012		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per- share amount
Class A – Basic EPS:						
	\$80	46,733,925	\$1.73	\$78	47,619,852	\$1.65

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Income available to Class A stockholders						
Dilutive effect of stock-based awards	0	92,126	—	0	79,943	—
Assumed conversion of Class B shares	1	6,100,800	—	1	6,108,000	—
Class A – Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	\$81	52,926,851	\$1.54	\$79	53,807,795	\$1.47
Class B – Basic and diluted EPS:						
Income available to Class B stockholders	\$1	2,542	\$259	\$1	2,545	\$249

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 June 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 second quarter and six months ended June 30, 2012 included an adjustment that reduced commission expense by \$6 million. 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 second quarters of 2013 and 2012, investment activities on life insurance related assets generated revenues of \$26 million and \$28 million, respectively, resulting in EFL reporting income before income taxes of \$13 million for both periods, before intercompany eliminations. Investment activities on life insurance related assets generated revenues of \$52 million for both the six months ended June 30, 2013 and 2012, resulting in EFL reporting income before income taxes of \$24 million and \$22 million, respectively, 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 June 30, 2013					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$1,196	\$20			\$(1 )	\$ 1,215
Net investment income				\$107		(3 )	104
Net realized investment gains				61			61
Net impairment losses recognized in earnings				(1 )			(1 )
Equity in earnings of limited partnerships				39			39
Management fee revenue	\$336					(336 )	—
Service agreement and other revenue	8		0				8
Total revenues	344	1,196	20	206		(340 )	1,426
Cost of management operations	285					(285 )	—
Insurance losses and loss expenses		837	26			(2 )	861
Policy acquisition and underwriting expenses		348	7			(53 )	302
Total benefits and expenses	285	1,185	33	—		(340 )	1,163
Income (loss) before income taxes	59	11	(13 )	206		—	263
Provision for income taxes	21	4	(5 )	66		—	86
Net income (loss)	\$38	\$7	\$(8 )	\$140		—	\$ 177

(in millions)	Erie Insurance Group Three months ended June 30, 2012					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$1,092	\$18			\$(1 )	\$ 1,109
Net investment income				\$115		(2 )	113
Net realized investment losses				(107 )			(107 )
Net impairment losses recognized in earnings				0			0
Equity in earnings of limited partnerships				37			37
Management fee revenue	\$308					(308 )	—
Service agreement and other revenue	8		0				8
Total revenues	316	1,092	18	45		(311 )	1,160
Cost of management operations	257					(257 )	—
Insurance losses and loss expenses		919	25			(1 )	943

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Policy acquisition and underwriting expense		332	8		(53	)	287
Total benefits and expenses	257	1,251	33	—	(311	)	1,230
Income (loss) before income taxes	59	(159	)	(15	)	45	)
Provision for income taxes	21	(55	)	(6	)	8	)
Net income (loss)	\$38	\$(104	)	\$(9	)	\$37	)
					\$—		\$(38
							)

Table of Contents

(in millions)	Erie Insurance Group Six months ended June 30, 2013					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$2,352	\$39			\$(1 )	\$ 2,390
Net investment income				\$213		(6 )	207
Net realized investment gains				310			310
Net impairment losses recognized in earnings				(1 )			(1 )
Equity in earnings of limited partnerships				75			75
Management fee revenue	\$632					(632 )	—
Service agreement and other revenue	15		1				16
Total revenues	647	2,352	40	597		(639 )	2,997
Cost of management operations	539					(539 )	—
Insurance losses and loss expenses		1,654	52			(3 )	1,703
Policy acquisition and underwriting expenses		676	16			(97 )	595
Total benefits and expenses	539	2,330	68	—		(639 )	2,298
Income (loss) before income taxes	108	22	(28 )	597		—	699
Provision for income taxes	38	8	(10 )	196		—	232
Net income (loss)	\$70	\$14	\$(18 )	\$401		\$—	\$ 467

(in millions)	Erie Insurance Group Six months ended June 30, 2012					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$2,161	\$36			\$(1 )	\$ 2,196
Net investment income				\$226		(5 )	221
Net realized investment gains				189			189
Net impairment losses recognized in earnings				0			0
Equity in earnings of limited partnerships				58			58
Management fee revenue	\$577					(577 )	—
Service agreement and other revenue	15		1				16
Total revenues	592	2,161	37	473		(583 )	2,680
Cost of management operations	487					(487 )	—
Insurance losses and loss expenses		1,611	50			(2 )	1,659
Policy acquisition and underwriting expenses		634	17			(94 )	557

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Total benefits and expenses	487	2,245	67	—	(583	) 2,216
Income (loss) before income taxes	105	(84	) (30	) 473	—	464
Provision for income taxes	37	(29	) (11	) 151	—	148
Net income (loss)	\$68	\$(55	) \$(19	) \$322	\$—	\$ 316

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 in the 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 structured 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 June 30, 2013:

(in millions)	Erie Insurance Group June 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	\$179	\$0	\$179	\$0
Corporate debt securities	258	0	257	1
Collateralized debt obligations	1	0	0	1
Total fixed maturities	438	0	436	2
Nonredeemable preferred stock	23	2	21	0
Common stock	25	25	0	0
Total available-for-sale securities	486	27	457	2
Other investments <sup>(1)</sup>	20	0	0	20
Total – Indemnity	\$506	\$27	\$457	\$22
<b>Exchange</b>				
Available-for-sale securities:				
U.S. government & agencies	\$184	\$0	\$184	\$0
States & political subdivisions	1,274	0	1,274	0
Foreign government securities	23	0	23	0
Corporate debt securities	5,882	0	5,849	33
Residential mortgage-backed securities	221	0	221	0
Commercial mortgage-backed securities	49	0	45	4
Collateralized debt obligations	23	0	11	12
Other debt securities	69	0	69	0
Total fixed maturities	7,725	0	7,676	49
Nonredeemable preferred stock	647	231	409	7
Common stock	322	322	0	0
Total available-for-sale securities	8,694	553	8,085	56
Trading securities:				
Common stock	2,724	2,717	0	7
Total trading securities	2,724	2,717	0	7
Other investments <sup>(1)</sup>	113	0	0	113
Total – Exchange	\$11,531	\$3,270	\$8,085	\$176
Total – Erie Insurance Group	\$12,037	\$3,297	\$8,542	\$198

(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 June 30, 2013. During the six months ended June 30, 2013, Indemnity made no contributions and received distributions totaling \$0.3 million, and the Exchange made no contributions and received distributions totaling \$2.5 million for these investments. As of June 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 June 30, 2013
	Beginning balance at March 31, 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	2	0	0	0	(1)	0	1
Total fixed maturities	3	0	0	0	(1)	0	2
Total available-for-sale securities	3	0	0	0	(1)	0	2
Other investments	20	0	0	0	0	0	20
Total Level 3 assets – Indemnity	\$23	\$0	\$0	\$0	\$(1)	\$0	\$22
<b>Exchange</b>							
Available-for-sale securities:							
Corporate debt securities	\$58	\$0	\$(1)	\$1	\$(2)	\$(23)	\$33
Commercial mortgage-backed securities	5	0	0	0	(1)	0	4
Collateralized debt obligations	14	1	(1)	0	(2)	0	12
Total fixed maturities	77	1	(2)	1	(5)	(23)	49
Nonredeemable preferred stock	12	2	(1)	0	(6)	0	7
Total available-for-sale securities	89	3	(3)	1	(11)	(23)	56
Trading securities:							
Common stock	7	0	0	0	0	0	7
Total trading securities	7	0	0	0	0	0	7
Other investments	112	2	0	0	(1)	0	113
Total Level 3 assets – Exchange	\$208	\$5	\$(3)	\$1	\$(12)	\$(23)	\$176
Total Level 3 assets – Erie Insurance Group	\$231	\$5	\$(3)	\$1	\$(13)	\$(23)	\$198

These amounts are reported in the Consolidated Statement of Operations. There is \$3 million included in net (1) realized investment gains (losses) and \$2 million included in equity in earnings of limited partnerships for the three months ended June 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 June 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 June 30, 2013. Level 3 to Level 2 transfers totaled \$23 million for three fixed maturity holdings. These transfers out of Level 3 were primarily the result of using observable market data to determine the fair value at June 30, 2013.

Table of Contents

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

(in millions)	Erie Insurance Group						Ending balance at June 30, 2013
	Beginning balance at December 31, 2012	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	3	0	0	0	(2 )	0	1
Total fixed maturities	4	0	0	0	(2 )	0	2
Total available-for-sale securities	4	0	0	0	(2 )	0	2
Other investments	19	1	0	0	0	0	20
Total Level 3 assets – Indemnity	\$23	\$1	\$ 0	\$ 0	\$(2 )	\$0	\$22
<b>Exchange</b>							
Available-for-sale securities:							
Corporate debt securities	\$43	\$0	\$ (1 )	\$ 1	\$(2 )	\$(8 )	\$33
Commercial mortgage-backed securities	0	0	(1 )	0	(1 )	6	4
Collateralized debt obligations	16	1	0	0	(7 )	2	12
Total fixed maturities	59	1	(2 )	1	(10 )	0	49
Nonredeemable preferred stock	0	0	3	4	0	0	7
Total available-for-sale securities	59	1	1	5	(10 )	0	56
Trading securities:							
Common stock	15	(3 )	0	0	(5 )	0	7
Total trading securities	15	(3 )	0	0	(5 )	0	7
Other investments	109	7	0	0	(3 )	0	113
Total Level 3 assets – Exchange	\$183	\$5	\$ 1	\$ 5	\$(18 )	\$0	\$176
Total Level 3 assets – Erie Insurance Group	\$206	\$6	\$ 1	\$ 5	\$(20 )	\$0	\$198

These amounts are reported in the Consolidated Statement of Operations. There is \$(2) million included in net (1) realized investment gains (losses) and \$8 million included in equity in earnings of limited partnerships for the six months ended June 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 six months ended June 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 \$5 million and Level 2 to Level 1 transfers totaled \$44 million due to trading activity levels related to one preferred stock holding and five preferred stock holdings, respectively, for the six months ended June 30, 2013. Level 2 to Level 3 transfers totaled \$18 million for five fixed maturity holdings and Level 3 to Level 2 transfers totaled \$18 million for two 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 June 30, 2013.

Table of Contents

## Quantitative and Qualitative Disclosures about Unobservable Inputs

(dollars in millions)	Erie Insurance Group June 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	112.82	
Collateralized debt obligations	1	2	Income approach	Projected maturity date	Sep 2014 - Apr 2015	
				Repayment at maturity	42 - 100%	78.6%
				Discount rate	7.5 - 15.0%	10.3%
				Projected LIBOR rate	0.28%	
Total Level 3 assets – Indemnity	\$2	3				
<b>Exchange</b>						
Corporate debt securities	33	8	Market approach	Non-binding broker quote	98.28 - 112.82	106.99
				Comparable transaction EBITDA multiples	6.7 - 17.1x	8.0x
				Comparable security yield	6.00%	
Commercial mortgage-backed securities	4	1	Market approach	Non-binding broker quote	100.75	
Collateralized debt obligations	9	4	Income approach	Projected maturity date	Sep 2014 - Oct 2035	
				Repayment at maturity	42 - 100%	92.5%
				Discount rate	7.0 - 15.0%	8.9%
				Projected LIBOR rate	0.28%	
	3	3	Market approach	Non-binding broker quote	13 - 61	49.33
Nonredeemable preferred stock	7	1	Market approach	Comparable transaction EBITDA multiples	6.7 - 17.1x	8.0x
Common stock	7	3	Market approach	Comparable transaction EBITDA multiples	6.7 - 17.1x	8.0x
				Discount for lack of marketability	5 - 30%	30%
Total Level 3 assets – Exchange	\$63	20				
Total Level 3 assets – Erie Insurance Group	\$65	23				



Securities valued using unobservable inputs shown above totaled \$65 million at June 30, 2013. Other investments representing certain limited partnerships recorded at fair value of \$133 million are also included in Level 3 within our consolidated fair value measurements. These values are based upon net asset value (NAV) information provided by the general partner. In total, Level 3 assets represent less than 1.7% of the assets measured at fair value on a recurring basis for the Erie Insurance Group.

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

Table of Contents

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.

Common stock investments, Nonredeemable preferred stock and Corporate debt securities – The unobservable inputs used in the fair value measurement of direct private equity common stock investments, certain corporate debt securities and certain nonredeemable preferred 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 June 30, 2012
	Beginning balance at March 31, 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	0	0	4
Total fixed maturities	5	0	0	0	0	0	5
Total available-for-sale securities	5	0	0	0	0	0	5
Other investments <sup>(3)</sup>	17	1	0	0	0	0	18
Total Level 3 assets – Indemnity	\$22	\$1	\$0	\$0	\$0	\$0	\$23
<b>Exchange</b>							
Available-for-sale securities:							
States & political subdivisions	\$5	\$0	\$ (1 )	\$0	\$0	\$0	\$4
Corporate debt securities	26	0	0	1	(4 )	0	23
Collateralized debt obligations	27	0	0	0	0	0	27
Other debt securities	5	0	0	0	0	0	5
Total fixed maturities	63	0	(1 )	1	(4 )	0	59
Nonredeemable preferred stock	6	(1 )	0	0	0	0	5
Total available-for-sale securities	69	(1 )	(1 )	1	(4 )	0	64
Trading securities:							
Common stock	14	0	0	0	0	0	14
Total trading securities	14	0	0	0	0	0	14
Other investments <sup>(3)</sup>	103	5	0	0	(1 )	0	107
Total Level 3 assets – Exchange	\$186	\$4	\$ (1 )	\$ 1	\$(5 )	\$0	\$185
Total Level 3 assets – Erie Insurance Group	\$208	\$5	\$ (1 )	\$ 1	\$(5 )	\$0	\$208

These amounts are reported in the Consolidated Statement of Operations. There is \$(1) million included in net (1) realized investment gains (losses) and \$6 million included in equity in earnings of limited partnerships for the three months ended June 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 June 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 \$1 million due to trading activity levels related to one preferred stock holding for the three months ended June 30, 2012. There were no transfers from Level 2 to Level 1 or between Levels 2 and 3.

For the Exchange, Level 1 to Level 2 transfers totaled \$20 million and Level 2 to Level 1 transfers totaled \$28 million due to trading activity levels related to four preferred stock holdings and three preferred stock holdings, respectively, for the three months ended June 30, 2012. There were no transfers between Levels 2 and 3.

Table of Contents

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

(in millions)	Erie Insurance Group						Ending balance at June 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	0	0	4
Total fixed maturities	4	0	0	0	0	1	5
Total available-for-sale securities	4	0	0	0	0	1	5
Other investments <sup>(3)</sup>	17	1	0	0	0	0	18
Total Level 3 assets – Indemnity	\$21	\$1	\$0	\$0	\$0	\$1	\$23
<b>Exchange</b>							
Available-for-sale securities:							
States & political subdivisions	\$4	\$0	\$0	\$0	\$0	\$0	\$4
Corporate debt securities	12	0	0	1	(4)	14	23
Collateralized debt obligations	29	0	0	0	(4)	2	27
Other debt securities	5	0	0	0	0	0	5
Total fixed maturities	50	0	0	1	(8)	16	59
Nonredeemable preferred stock	5	0	0	0	0	0	5
Total available-for-sale securities	55	0	0	1	(8)	16	64
Trading securities:							
Common stock	12	2	0	0	0	0	14
Total trading securities	12	2	0	0	0	0	14
Other investments <sup>(3)</sup>	102	6	0	1	(2)	0	107
Total Level 3 assets – Exchange	\$169	\$8	\$0	\$2	\$(10)	\$16	\$185
Total Level 3 assets – Erie Insurance Group	\$190	\$9	\$0	\$2	\$(10)	\$17	\$208

These amounts are reported in the Consolidated Statement of Operations. There is \$2 million included in net (1) realized investment gains (losses) and \$7 million included in equity in earnings of limited partnerships for the six months ended June 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 six months ended June 30, 2012.

For Indemnity, Level 1 to Level 2 transfers totaled \$1 million due to trading activity levels related to one preferred stock holding and there were no transfers from Level 2 to Level 1 for the six months ended June 30, 2012. Level 2 to Level 3 transfers totaled \$1 million for one fixed maturity holding and there were no transfers from Level 3 to Level 2. These transfers into Level 3 were primarily the result of using non-binding broker quotes to determine the fair value

at June 30, 2012.

For the Exchange, Level 1 to Level 2 transfers totaled \$20 million and Level 2 to Level 1 transfers totaled \$27 million due to trading activity levels related to four preferred stock holdings and three preferred stock holdings, respectively, for the six months ended June 30, 2012. Level 2 to Level 3 transfers totaled \$16 million for six fixed maturity holdings and there were no transfers from Level 3 to Level 2. These transfers into Level 3 were primarily the result of using non-binding broker quotes to determine the fair value at June 30, 2012.



Table of Contents

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

(in millions)	Erie Insurance Group			
	June 30, 2013			
	Total	Level 1	Level 2	Level 3
<b>Indemnity</b>				
Fixed maturities:				
Priced via pricing services	\$426	\$0	\$426	\$0
Priced via market comparables/broker quotes <sup>(1)</sup>	11	0	10	1
Priced via internal modeling	1	0	0	1
Total fixed maturities	438	0	436	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>	20	0	0	20
Total other investments	20	0	0	20
Total – Indemnity	\$506	\$27	\$457	\$22
<b>Exchange</b>				
Fixed maturities:				
Priced via pricing services	\$7,580	\$0	\$7,580	\$0
Priced via market comparables/broker quotes <sup>(1)</sup>	128	0	96	32
Priced via internal modeling	17	0	0	17
Total fixed maturities	7,725	0	7,676	49
Nonredeemable preferred stock:				
Priced via pricing services	625	231	394	0
Priced via market comparables/broker quotes <sup>(1)</sup>	15	0	15	0
Priced via internal modeling	7	0	0	7
Total nonredeemable preferred stock	647	231	409	7
Common stock:				
Priced via pricing services	3,039	3,039	0	0
Priced via market comparables/broker quotes <sup>(1)</sup>	0	0	0	0
Priced via internal modeling	7	0	0	7
Total common stock	3,046	3,039	0	7
Other investments:				
Priced via unobservable inputs <sup>(2)</sup>	113	0	0	113
Total other investments	113	0	0	113
Total – Exchange	\$11,531	\$3,270	\$8,085	\$176
Total – Erie Insurance Group	\$12,037	\$3,297	\$8,542	\$198

(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 six months ended June 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 June 30, 2013:

(in millions)	Erie Insurance Group			
	June 30, 2013			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Indemnity				
Available-for-sale securities:				
States & political subdivisions	\$ 172	\$ 7	\$ 0	\$ 179
Corporate debt securities	257	2	1	258
Collateralized debt obligations	1	0	0	1
Total fixed maturities	430	9	1	438
Nonredeemable preferred stock	21	2	0	23
Common stock	26	0	1	25
Total available-for-sale securities – Indemnity	\$477	\$ 11	\$ 2	\$486
Exchange				
Available-for-sale securities:				
U.S. government & agencies	\$ 188	\$ 1	\$ 5	\$ 184
States & political subdivisions	1,226	61	13	1,274
Foreign government securities	23	1	1	23
Corporate debt securities	5,570	365	53	5,882
Residential mortgage-backed securities	222	3	4	221
Commercial mortgage-backed securities	48	2	1	49
Collateralized debt obligations	16	7	0	23
Other debt securities	66	3	0	69
Total fixed maturities	7,359	443	77	7,725
Nonredeemable preferred stock	577	74	4	647
Common stock	338	0	16	322
Total available-for-sale securities – Exchange	\$8,274	\$ 517	\$ 97	\$8,694
Total available-for-sale securities – Erie Insurance Group	\$8,751	\$ 528	\$ 99	\$9,180

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
Indemnity				
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
Exchange				
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 June 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 June 30, 2013	
	Amortized cost	Estimated fair value
Indemnity		
Due in one year or less	\$ 127	\$ 127
Due after one year through five years	198	201
Due after five years through ten years	34	36
Due after ten years	71	74
Total fixed maturities – Indemnity	\$430	\$438

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Exchange		
Due in one year or less	476	486
Due after one year through five years	2,730	2,890
Due after five years through ten years	2,655	2,798
Due after ten years	1,498	1,551
Total fixed maturities – Exchange	\$7,359	\$7,725
Total fixed maturities – Erie Insurance Group	\$7,789	\$8,163

25

---

Table of Contents

Available-for-sale securities in a gross unrealized loss position at June 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							
	June 30, 2013							
	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:								
States & political subdivisions	\$16	\$0	\$0	\$0	\$16	\$0		7
Corporate debt securities	122	1	0	0	122	1		23
Total fixed maturities	138	1	0	0	138	1		30
Nonredeemable preferred stock	6	0	3	0	9	0		4
Common stock	25	1	0	0	25	1		2
Total available-for-sale securities – Indemnity	\$169	\$2	\$3	\$0	\$172	\$2		36
Quality breakdown of fixed maturities:								
Investment grade	\$132	\$1	\$0	\$0	\$132	\$1		29
Non-investment grade	6	0	0	0	6	0		1
Total fixed maturities – Indemnity	\$138	\$1	\$0	\$0	\$138	\$1		30
Exchange								
Available-for-sale securities:								
U.S. government & agencies	\$151	\$5	\$0	\$0	\$151	\$5		12
States & political subdivisions	284	13	0	0	284	13		65
Foreign government securities	13	1	0	0	13	1		2
Corporate debt securities	1,196	52	11	1	1,207	53		217
Residential mortgage-backed securities	122	4	7	0	129	4		21
Commercial mortgage-backed securities	15	1	0	0	15	1		3
Other debt securities	30	0	0	0	30	0		5
Total fixed maturities	1,811	76	18	1	1,829	77		325
Nonredeemable preferred stock	110	3	15	1	125	4		19
Common stock	322	16	0	0	322	16		3
Total available-for-sale securities – Exchange	\$2,243	\$95	\$33	\$2	\$2,276	\$97		347
Quality breakdown of fixed maturities:								
Investment grade	\$1,713	\$72	\$18	\$1	\$1,731	\$73		305
Non-investment grade	98	4	0	0	98	4		20
Total fixed maturities – Exchange	\$1,811	\$76	\$18	\$1	\$1,829	\$77		325

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 debt 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 debt 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			
	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Indemnity				
Fixed maturities	\$3	\$3	\$6	\$6
Equity securities	0	1	1	2
Cash equivalents and other	1	0	1	0
Total investment income	4	4	8	8
Less: investment expenses	1	0	1	0
Investment income, net of expenses – Indemnity	\$3	\$4	\$7	\$8
Exchange				
Fixed maturities	\$83	\$89	\$166	\$179
Equity securities	27	27	51	49
Cash equivalents and other	0	1	0	2
Total investment income	110	117	217	230
Less: investment expenses	9	8	17	17
Investment income, net of expenses – Exchange	\$101	\$109	\$200	\$213
Investment income, net of expenses – Erie Insurance Group	\$104	\$113	\$207	\$221



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			
	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Indemnity				
Available-for-sale securities:				
Fixed maturities:				
Gross realized gains	\$0	\$0	\$0	\$0
Gross realized losses	0	0	0	0
Net realized gains	0	0	0	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 (decreases) in fair value <sup>(1)</sup>	0	(1	) 0	1
Net realized gains (losses)	0	(1	) 0	2
Net realized investment gains (losses) – Indemnity	\$0	\$(1	) \$0	\$2
Exchange				
Available-for-sale securities:				
Fixed maturities:				
Gross realized gains	\$7	\$16	\$22	\$25
Gross realized losses	(3	) (3	) (5	) (6
Net realized gains	4	13	17	19
Equity securities:				
Gross realized gains	2	4	4	5
Gross realized losses	0	(2	) 0	(2
Net realized gains	2	2	4	3
Trading securities:				
Common stock:				
Gross realized gains	54	44	156	85
Gross realized losses	(3	) (21	) (15	) (33
Increases (decreases) in fair value <sup>(1)</sup>	4	(144	) 148	113
Net realized gains (losses)	55	(121	) 289	165
Net realized investment gains (losses) – Exchange	\$61	\$(106	) \$310	\$187
Net realized investment gains (losses) – Erie Insurance Group	\$61	\$(107	) \$310	\$189

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

Net impairment losses

Net impairment losses recorded in earnings for Indemnity for the second quarter and six months ended June 30, 2013 were \$0.1 million, compared to no net impairment losses for the second quarter and six months ended June 30, 2012. Net impairment losses for the Exchange were \$1 million for the second quarter and the six months ended June 30, 2013, compared to no net impairment losses for the second quarter of 2012, and \$0.1 million for the six months ended June 30, 2012.

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.

Table of Contents

## 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 June 30, 2013 are comprised of partnership financial results for the fourth quarter of 2012 and first quarter of 2013. Given the lag in reporting, our limited partnership results do not reflect the market conditions of the second 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 six months ended June 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.

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

(dollars in millions)	Erie Insurance Group			
	As of and for the six months ended June 30, 2013			
	Number of partnerships	Asset recorded	Income (loss) recognized due to valuation adjustments by the partnerships	Income (loss) recorded
Investment percentage in limited partnerships				
Indemnity				
Private equity:				
Less than 10%	26	\$52	\$(5 )	\$5
Greater than or equal to 10% but less than 50%	3	15	2	0
Greater than 50%	0	0	0	0
Total private equity	29	67	(3 )	5
Mezzanine debt:				
Less than 10%	11	15	0	0
Greater than or equal to 10% but less than 50%	3	8	(1 )	2
Greater than 50%	1	0	0	0
Total mezzanine debt	15	23	(1 )	2
Real estate:				
Less than 10%	12	51	0	0
Greater than or equal to 10% but less than 50%	3	16	1	2
Greater than 50%	3	9	2	0
Total real estate	18	76	3	2
Total limited partnerships – Indemnity	62	\$166	\$(1 )	\$9
Exchange				
Private equity:				
Less than 10%	43	\$410	\$(29 )	\$54
Greater than or equal to 10% but less than 50%	3	64	7	0
Greater than 50%	0	0	0	0

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Total private equity	46	474	(22	)	54
Mezzanine debt:					
Less than 10%	19	128	1		7
Greater than or equal to 10% but less than 50%	4	24	(4	)	5
Greater than 50%	3	35	1		2
Total mezzanine debt	26	187	(2	)	14
Real estate:					
Less than 10%	22	237	(7	)	15
Greater than or equal to 10% but less than 50%	6	81	2		7
Greater than 50%	3	32	(1	)	7
Total real estate	31	350	(6	)	29
Total limited partnerships – Exchange	103	\$1,011	\$(30	)	\$97
Total limited partnerships – Erie Insurance Group		\$1,177	\$(31	)	\$106

Per the limited partnership financial statements, total partnership assets were \$51 billion and total partnership liabilities were \$5 billion at June 30, 2013 (as recorded in the March 31, 2013 limited partnership financial statements). For the six month period comparable to that presented in the preceding table (fourth quarter of 2012 and first quarter of 2013), total partnership valuation adjustment gains were \$1 billion and total partnership net income was \$3 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 June 30, 2013, Indemnity has available a \$100 million bank revolving line of credit that expires on November 3, 2016. There were no borrowings outstanding on the line of credit as of June 30, 2013. Bonds with a fair value of \$111 million were pledged as collateral on the line at June 30, 2013.

As of June 30, 2013, the Exchange has available a \$300 million bank revolving line of credit that expires on October 28, 2016. There were no borrowings outstanding on the line of credit as of June 30, 2013. Bonds with a fair value of \$331 million were pledged as collateral on the line at June 30, 2013.

Securities pledged as collateral on both lines have no trading restrictions and are reported as available-for-sale fixed maturities in the Consolidated Statements of Financial Position as of June 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 June 30, 2013.

## 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 June 30, 2013, we recorded a net deferred tax liability of \$269 million on our Consolidated Statements of Financial Position. Of this amount, \$43 million is a net deferred tax asset attributable to Indemnity and \$312 million is a net deferred tax liability attributable to the Exchange. There was no deferred tax valuation allowance recorded at June 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.

## 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 June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Service cost for benefits earned	\$6	\$6	\$13	\$11

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Interest cost on benefits obligation	7	6	13	12	
Expected return on plan assets	(7	) (7	) (15	) (14	)
Prior service cost amortization	1	0	1	0	
Net actuarial loss amortization	3	3	7	6	
Pension plan cost	\$10	\$8	\$19	\$15	

32

---



Table of Contents

## 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 six months ended June 30, 2013. In the first quarter 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 \$53 million of repurchase authority remaining under this program at June 30, 2013.

## 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 six months ended June 30, 2013:

(in millions)	Indemnity Shareholder Interest		Total
	Unrealized holding gains (losses) on available-for-sale securities	Postretirement plans <sup>(2)</sup>	
Balance at December 31, 2012	\$13	\$(146)	\$(133)
Other comprehensive loss before reclassifications, net of tax	(5)	0	(5)
Amounts reclassified from accumulated other comprehensive loss, net of tax <sup>(1)</sup>	0	0	0
Net current period other comprehensive loss, net of tax	(5)	0	(5)
Balance at June 30, 2013	\$8	\$(146)	\$(138)

(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 six months ended June 30, 2013:

(in millions)	Erie Insurance Group	
	Three months ended June 30, 2013	Six months ended June 30, 2013
Unrealized holding gains (losses) on available-for-sale securities:		
Net realized investment gains	\$6	\$21
Net impairment losses recognized in earnings	(1)	(1)

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Income from operations before income taxes and noncontrolling interest	5	20
Provision for income taxes	2	7
Net income	3	13
Less: Net income attributable to noncontrolling interest in consolidated entity – Exchange	3	13
Net income attributable to Indemnity	\$0	\$0
Amortization of postretirement plan items <sup>(2)</sup> :		
Net income attributable to Indemnity	\$0	\$0
Net income attributable to Indemnity	\$0	\$0

(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 six months ended June 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	81	386	467
Change in other comprehensive loss, net of tax	(5	) (214	) (219
Net purchase of treasury stock	(16	) —	(16
Dividends declared:			)
Class A \$1.185 per share	(55	) —	(55
Class B \$177.750 per share	0	—	0
Balance at June 30, 2013	\$647	\$6,321	\$6,968

## Note 14. Commitments and Contingencies

Indemnity has contractual commitments to invest up to \$30 million related to its limited partnership investments at June 30, 2013. These commitments are split between 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 \$393 million related to its limited partnership investments at June 30, 2013. These commitments are split between private equity securities of \$142 million, mezzanine debt securities of \$163 million, and real estate activities of \$88 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 June 30, 2013			
	Indemnity shareholder interest	Exchange noncontrolling interest	Reclassifications and eliminations	Erie Insurance Group
Assets				
Investments				
Available-for-sale securities, at fair value:				
Fixed maturities	\$438	\$7,725	\$—	\$8,163
Equity securities	48	969	—	1,017
Trading securities, at fair value	0	2,724	—	2,724
Limited partnerships	166	1,011	—	1,177
Other invested assets	1	20	—	21
Total investments	653	12,449	—	13,102
Cash and cash equivalents	39	326	—	365
Premiums receivable from policyholders	—	1,191	—	1,191
Reinsurance recoverable	—	174	—	174
Deferred income tax asset	43	0	—	43
Deferred acquisition costs	—	553	—	553
Other assets	115	336	—	451
Receivables from the Exchange and other affiliates	309	—	(309	) —
Note receivable from EFL	25	—	(25	) —
Total assets	\$1,184	\$15,029	\$(334	) \$15,879
Liabilities				
Losses and loss expense reserves	\$—	\$3,668	\$—	\$3,668
Life policy and deposit contract reserves	—	1,739	—	1,739
Unearned premiums	—	2,553	—	2,553
Deferred income tax liability	0	312	—	312
Other liabilities	537	436	(334	) 639

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Total liabilities	537	8,708	(334	) 8,911
Shareholders' equity and noncontrolling interest				
Total Indemnity shareholders' equity	647	—	—	647
Noncontrolling interest in consolidated entity – Exchange	—	6,321	—	6,321
Total equity	647	6,321	—	6,968
Total liabilities, shareholders' equity and noncontrolling interest	\$1,184	\$15,029	\$(334	) \$15,879

35

---

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 \$305 million and \$278 million at June 30, 2013 and December 31, 2012, respectively. The receivable from EFL for expense allocations and interest on the surplus note totaled \$4 million and \$3 million at June 30, 2013 and December 31, 2012, respectively.

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 six months ended June 30, 2013 and 2012, Indemnity recognized interest income on the note of \$0.8 million.



Table of Contents

## Income attributable to Indemnity shareholder interest

(in millions)	Indemnity Shareholder Interest			
	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Management operations:				
Management fee revenue, net	\$336	\$308	\$632	\$577
Service agreement revenue	8	8	15	15
Total revenue from management operations	344	316	647	592
Cost of management operations	285	257	539	487
Income from management operations before taxes	59	59	108	105
Investment operations:				
Net investment income	3	4	7	8
Net realized gains (losses) on investments	0	(1	) 0	2
Net impairment losses recognized in earnings	0	0	0	0
Equity in earnings of limited partnerships	5	3	8	4
Income from investment operations before taxes	8	6	15	14
Income from operations before income taxes	67	65	123	119
Provision for income taxes	23	22	42	40
Net income attributable to Indemnity	\$44	\$43	\$81	\$79

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

(in millions)	Indemnity Shareholder Interest		
	Six months ended June 30,		
	2013	2012	
Management fee received	\$604	\$555	
Service agreement fee received	15	15	
Net investment income received	11	14	
Limited partnership distributions	12	6	
Decrease in reimbursements collected from affiliates	0	(1	)
Commissions and bonuses paid to agents	(356	) (320	)
Salaries and wages paid	(76	) (67	)
Pension contribution and employee benefits paid	(28	) (30	)
General operating expenses paid	(83	) (68	)
Income taxes paid	(42	) (38	)
Net cash provided by operating activities	57	66	
Net cash provided by investing activities	15	33	
Net cash used in financing activities	(45	) (97	)
Net increase in cash and cash equivalents	27	2	
Cash and cash equivalents at beginning of period	12	11	
Cash and cash equivalents at end of period	\$39	\$13	

## Note 16. Subsequent Events

No items were identified in this period subsequent to the financial statement date that required adjustment or disclosure.

37

---

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>38</u>
<u>Recent Accounting Pronouncements</u>	<u>39</u>
<u>Operating Overview</u>	<u>40</u>
<u>Results of Operations</u>	<u>46</u>
<u>Management Operations</u>	<u>46</u>
<u>Property and Casualty Insurance Operations</u>	<u>48</u>
<u>Life Insurance Operations</u>	<u>52</u>
<u>Investment Operations</u>	<u>53</u>
<u>Financial Condition</u>	<u>56</u>
<u>Investments</u>	<u>56</u>
<u>Liabilities</u>	<u>60</u>
<u>Impact of Inflation</u>	<u>61</u>
<u>Liquidity and Capital Resources</u>	<u>61</u>
<u>Critical Accounting Estimates</u>	<u>64</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.

40

---

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 June 30, 2013

(in millions)	Indemnity shareholder interest		Noncontrolling interest (Exchange)		Eliminations of related party transactions		Erie Insurance Group	
	Three months ended June 30,		Three months ended June 30,		Three months ended June 30,		Three months ended June 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Management operations:								
Management fee revenue, net	\$ 336	\$ 308	\$—	\$—	\$(336 )	\$(308 )	\$—	\$—
Service agreement revenue	8	8	—	—	—	—	8	8
Total revenue from management operations	344	316	—	—	(336 )	(308 )	8	8
Cost of management operations	285	257	—	—	(285 )	(257 )	—	—
Income from management operations before taxes	59	59	—	—	(51 )	(51 )	8	8
Property and casualty insurance operations:								
Net premiums earned	—	—	1,196	1,092	—	—	1,196	1,092
Losses and loss expenses	—	—	837	919	(2 )	(1 )	835	918
Policy acquisition and underwriting expenses	—	—	348	332	(53 )	(53 )	295	279
Income (loss) from property and casualty insurance operations before taxes	—	—	11	(159 )	55	54	66	(105 )
Life insurance operations: <sup>(1)</sup>								
Total revenue	—	—	46	46	(1 )	(1 )	45	45
Total benefits and expenses	—	—	33	33	0	0	33	33
Income from life insurance operations before taxes	—	—	13	13	(1 )	(1 )	12	12
Investment operations:								
Net investment income	3	4	81	87	(3 )	(2 )	81	89
Net realized gains (losses) on investments	0	(1 )	58	(110 )	—	—	58	(111 )
Net impairment losses recognized in earnings	0	0	0	0	—	—	0	0
Equity in earnings of limited partnerships	5	3	33	34	—	—	38	37
Income from investment operations before taxes	8	6	172	11	(3 )	(2 )	177	15
Income (loss) from operations before income taxes and noncontrolling interest	67	65	196	(135 )	—	—	263	(70 )
Provision for income taxes	23	22	63	(54 )	—	—	86	(32 )
Net income (loss)	\$ 44	\$ 43	\$ 133	\$(81 )	\$—	\$—	\$ 177	\$(38 )



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 second quarter of 2013 benefited from improved results in our property and casualty insurance and investment operations, compared to the second quarter of 2012. The Exchange's property and casualty insurance operations experienced a 9.4% increase in earned premium, driven by increases in policies in force and the average premium per policy. Losses from the Exchange's property and casualty insurance operations decreased due to lower levels of catastrophe losses, offset slightly by adverse development on prior accident year loss reserves, compared to favorable development in the second quarter of 2012. Our investment operations were positively impacted by net realized gains on investments generated in the second quarter of 2013 due to the sale of common stocks, compared to net realized losses in the second quarter of 2012 resulting from declines in the fair value of our common stock portfolio.

Table of Contents

Six months ended June 30, 2013

(in millions)	Indemnity shareholder interest		Noncontrolling interest (Exchange)		Eliminations of related party transactions		Erie Insurance Group	
	Six months ended June 30, 2013	Six months ended June 30, 2012	Six months ended June 30, 2013	Six months ended June 30, 2012	Six months ended June 30, 2013	Six months ended June 30, 2012	Six months ended June 30, 2013	Six months ended June 30, 2012
Management operations:								
Management fee revenue, net	\$ 632	\$ 577	\$—	\$—	\$(632 )	\$(577 )	\$—	\$—
Service agreement revenue	15	15	—	—	—	—	15	15
Total revenue from management operations	647	592	—	—	(632 )	(577 )	15	15
Cost of management operations	539	487	—	—	(539 )	(487 )	—	—
Income from management operations before taxes	108	105	—	—	(93 )	(90 )	15	15
Property and casualty insurance operations:								
Net premiums earned	—	—	2,352	2,161	—	—	2,352	2,161
Losses and loss expenses	—	—	1,654	1,611	(3 )	(2 )	1,651	1,609
Policy acquisition and underwriting expenses	—	—	676	634	(97 )	(94 )	579	540
Income (loss) from property and casualty insurance operations before taxes	—	—	22	(84 )	100	96	122	12
Life insurance operations: <sup>(1)</sup>								
Total revenue	—	—	92	89	(1 )	(1 )	91	88
Total benefits and expenses	—	—	68	67	0	0	68	67
Income from life insurance operations before taxes	—	—	24	22	(1 )	(1 )	23	21
Investment operations:								
Net investment income	7	8	160	170	(6 )	(5 )	161	173
Net realized gains on investments	0	2	304	183	—	—	304	185
Net impairment losses recognized in earnings	0	0	0	0	—	—	0	0
Equity in earnings of limited partnerships	8	4	66	54	—	—	74	58
Income from investment operations before taxes	15	14	530	407	(6 )	(5 )	539	416
Income from operations before income taxes and noncontrolling interest	123	119	576	345	—	—	699	464
Provision for income taxes	42	40	190	108	—	—	232	148
Net income	\$ 81	\$ 79	\$386	\$237	\$—	\$—	\$467	\$316

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<sup>(1)</sup> 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 six months of 2013 benefited from improved results in our property and casualty insurance and investment operations, compared to the first six months of 2012. The Exchange's property and casualty insurance operations experienced an 8.8% increase in earned premium, driven by increases in policies in force and the average premium per policy, while losses grew only 2.6% during the same period due to reduced levels of catastrophe losses, offset by increased current accident year non-catastrophe losses and a slight deficiency in prior accident year loss reserves. Our investment operations generated higher levels of net realized gains on investments in the first six months of 2013, primarily due to higher net realized gains on the sale of common stocks and increases in the fair value of common stocks, compared to the first six 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		Six months ended June	
	June 30, 2013 (Unaudited)	2012	30, 2013 (Unaudited)	2012
Operating income attributable to Indemnity	\$44	\$44	\$81	\$78
Net realized gains (losses) and impairments on investments	0	(1	) 0	2
Income tax (expense) benefit	0	0	0	(1
Realized gains (losses) and impairments, net of income taxes	0	(1	) 0	1
Net income attributable to Indemnity	\$44	\$43	\$81	\$79
Per Indemnity Class A common share-diluted:				
Operating income attributable to Indemnity	\$0.84	\$0.82	\$1.54	\$1.45
Net realized gains (losses) and impairments on investments	0.00	(0.03	) 0.00	0.03
Income tax (expense) benefit	0.00	0.01	0.00	(0.01
Realized gains (losses) and impairments, net of income taxes	0.00	(0.02	) 0.00	0.02
Net income attributable to Indemnity	\$0.84	\$0.80	\$1.54	\$1.47

## Summary of Results – Indemnity Shareholder Interest

## Three months ended June 30, 2013

Net income attributable to Indemnity per share-diluted was \$0.84 per share in the second quarter of 2013, compared to \$0.80 per share in the second quarter of 2012.

Operating income attributable to Indemnity per share-diluted (excluding net realized gains or losses, impairments on investments and related taxes) was \$0.84 per share in the second quarter of 2013, compared to \$0.82 per share in the second quarter of 2012.

## Six months ended June 30, 2013

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Net income attributable to Indemnity per share-diluted was \$1.54 per share for the six months ended June 30, 2013, compared to \$1.47 per share for the six months ended June 30, 2012.

Operating income attributable to Indemnity per share-diluted (excluding net realized gains or losses, impairments on investments and related taxes) was \$1.54 per share for the six months ended June 30, 2013, compared to \$1.45 per share for the six months ended June 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 10,500 licensed property and casualty representatives, will contribute to future growth as new agents build their books of business with the Property and Casualty Group.

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.

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.

Table of Contents

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.

Earnings from our investment operations increased in the second quarter of 2013, compared to the second quarter of 2012. Net realized gains totaled \$61 million in the second quarter of 2013, compared to losses of \$107 million in the prior year quarter, primarily reflecting net realized gains from sales of common stock in the second quarter of 2013, compared to decreases in fair value of common stock recorded in the second quarter of 2012. Net investment income totaled \$104 million in the second quarter of 2013, compared to \$113 million in the second quarter of 2012. Equity in earnings of limited partnerships was \$39 million in the second quarter of 2013, compared to \$37 million in the second 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 second quarter 2013 partnership earnings reflect the market conditions experienced in the first 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			Six months ended June 30,			
	Three months ended June 30,			Six months ended June 30,			
	2013	2012	% Change	2013	2012	% Change	
	(Unaudited)			(Unaudited)			
Management fee revenue, net	\$336	\$308	9.0 %	\$632	\$577	9.6 %	
Service agreement revenue	8	8	0.5	15	15	(0.2 )	
Total revenue from management operations	344	316	8.8	647	592	9.3	
Cost of management operations	285	257	10.6	539	487	10.7	
Income from management operations – Indemnity <sup>(1)</sup>	\$59	\$59	0.9 %	\$108	\$105	2.7 %	
Gross margin	17.3	% 18.6	% (1.3 )pts.	16.7	% 17.8	% (1.1 )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			Six months ended June 30,			
	Three months ended June 30,			Six months ended June 30,			
	2013	2012	% Change	2013	2012	% Change	
	(Unaudited)			(Unaudited)			
Property and Casualty Group direct written premium	\$1,354	\$1,239	9.3 %	\$2,541	\$2,317	9.7 %	
Management fee rate	25	% 25	%	25	% 25	%	
Management fee revenue, gross	338	309	9.3	635	579	9.7	
Change in allowance for management fee returned on cancelled policies <sup>(1)</sup>	(2 )	(1 )	NM	(3 )	(2 )	NM	
Management fee revenue, net of allowance	\$336	\$308	9.0 %	\$632	\$577	9.6 %	

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 9.3% in the second quarter of 2013, compared to the second quarter of 2012, due to a 4.4% increase in policies in force and a 4.8% increase in the year-over-year average premium per policy for all lines of business. The year-over-year policy retention ratio was 90.9% at June 30, 2013 and December 31, 2012, compared to 90.7% at June 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 flat, totaling \$8 million in both the second quarters of 2013 and 2012, and \$15 million for both the six months ended June 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			Six months ended June 30,			
	Three months ended June 30, 2013 (Unaudited)	2012	% Change	2013 (Unaudited)	2012	% Change	
Commissions	\$187	\$165	13.3	% \$351	\$314	11.8	%
Non-commission expense	98	92	5.9		188	173	8.8
Total cost of management operations	\$285	\$257	10.6	% \$539	\$487	10.7	%

Commissions – Commissions increased \$22 million in the second quarter of 2013 and \$37 million for the six months ended June 30, 2013, compared to the same respective periods in 2012. These increases were primarily as a result of the 9.3% and 9.7%, respectively, increase in direct written premium of the Property and Casualty Group, combined with a slight increase in agent bonuses due to an increase in the profitability component of the bonus as a result of factoring in the most recent year's underwriting data. Additionally, impacting the second quarter and six months ended June 30, 2012 was an adjustment that reduced commission expense by \$6 million. 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 \$6 million in the second quarter of 2013, compared to the second quarter of 2012. Sales, policy issuance, and underwriting costs increased \$1 million. Personnel costs increased \$4 million as a result of a \$2 million increase in salaries, a \$1 million increase in pension costs, and a \$1 million increase in the estimate for incentive plan compensation related to growth and underwriting performance. All other operating costs increased \$1 million.

Non-commission expense increased \$15 million in the six months ended June 30, 2013, compared to the six months ended June 30, 2012. Sales, policy issuance, and underwriting costs increased \$3 million. Personnel costs increased \$9 million as a result of a \$3 million increase in salaries, a \$3 million increase in pension and medical costs, and a \$3 million increase in the estimate for incentive plan compensation related to growth and underwriting performance. All other operating costs increased \$3 million, which included a \$2 million increase related to professional fees.

## Gross margin

The gross margin in the second quarter of 2013 was 17.3%, compared to 18.6% in the second quarter of 2012, and was 16.7% for the six months ended June 30, 2013, compared to 17.8% for the six months ended June 30, 2012. Excluding the adjustment that reduced commission expense by \$6 million, the gross margin would have been 16.8% for both the second quarter and six months ended June 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			Six months ended June 30,		
	Three months ended June 30, 2013 (Unaudited)	2012	% Change	2013 (Unaudited)	2012	% Change
Premiums:						
Direct written premium	\$1,354	\$1,239	9.3 %	\$2,541	\$2,317	9.7 %
Reinsurance – assumed and ceded	(3 )	(8 )	60.4	(16 )	(14 )	(11.3 )
Net written premium	1,351	1,231	9.7	2,525	2,303	9.7
Change in unearned premium	155	139	12.1	173	142	22.2
Net premiums earned	1,196	1,092	9.4	2,352	2,161	8.8
Losses and loss expenses:						
Current accident year, excluding catastrophe losses	774	720	7.4	1,557	1,406	10.7
Current accident year catastrophe losses	45	204	(78.1 )	72	229	(68.7 )
Prior accident years, including prior year catastrophe losses	18	(5 )	NM	25	(24 )	NM
Losses and loss expenses	837	919	(9.0 )	1,654	1,611	2.6
Policy acquisition and other underwriting expenses	348	332	4.8	676	634	6.6
Total losses and expenses	1,185	1,251	(5.4 )	2,330	2,245	3.7
Underwriting income – Exchange <sup>(1)</sup>	\$11	\$(159 )	NM %	\$22	\$(84 )	NM %
Loss and loss expense ratios:						
Current accident year loss ratio, excluding catastrophe losses	64.8 %	65.9 %	(1.1 )pts.	66.2 %	65.1 %	1.1 pts.
Current accident year catastrophe loss ratio	3.7	18.7	(15.0 )	3.0	10.6	(7.6 )
Prior accident year loss ratio, including prior year catastrophe losses	1.5	(0.4 )	1.9	1.1	(1.1 )	2.2
Total loss and loss expense ratio	70.0	84.2	(14.2 )	70.3	74.6	(4.3 )
Policy acquisition and other underwriting expense ratio	29.1	30.4	(1.3 )	28.7	29.3	(0.6 )
Combined ratio	99.1 %	114.6 %	(15.5 )pts.	99.0 %	103.9 %	(4.9 )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 9.3% to \$1.4 billion in the second quarter of 2013, from \$1.2 billion in the second 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 4.4% in the second quarter of 2013 as the result of continuing strong policyholder retention and an increase in new policies written, compared to an increase of 3.1% in the second quarter of 2012. The year-over-year average premium per policy for all lines of business increased 4.8% at June 30, 2013, compared to 3.7% at June 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 11.8% to \$173 million in the second quarter of 2013, compared to an increase of 27.8% to \$154 million in the second quarter of 2012. Underlying the trend in new business premiums was a 11.1% increase in new business policies written in the second quarter of 2013, compared to 17.2% in the second quarter of 2012, while the year-over-year average premium per policy on new business increased 4.6% at June 30, 2013, compared to 6.7% at June 30, 2012.

Table of Contents

Premiums generated from renewal business increased 8.9% to \$1.2 billion in the second quarter of 2013, compared to an increase of 5.9% to \$1.1 billion in the second 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 4.9% at June 30, 2013, compared to 3.3% at June 30, 2012. The Property and Casualty Group's year-over-year policy retention ratio was 90.9% at June 30, 2013 and December 31, 2012, and 90.7% at June 30, 2012.

Personal lines – Total personal lines premiums written increased 8.7% to \$963 million in the second quarter of 2013, from \$886 million in the second quarter of 2012, driven by an increase of 4.4% 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 18.8% in the second quarter of 2013, compared to 23.8% in the second quarter of 2012, driven by increases in new business policies written and average premium per policy. Personal lines new business policies written increased 13.3% in the second quarter of 2013, compared to 19.0% in the second quarter of 2012, while the year-over-year average premium per policy on personal lines new business increased 5.0% at June 30, 2013, compared to 4.6% at June 30, 2012.

Private passenger auto new business premiums written increased 20.0% in the second quarter of 2013, compared to 18.2% in the second quarter of 2012. New business policies written for private passenger auto increased 16.2% in the second quarter of 2013, compared to 15.1% in the second quarter of 2012, while the new business year-over-year average premium per policy for private passenger auto increased 3.3% at June 30, 2013, compared to 3.0% at June 30, 2012.

Homeowners new business premiums written increased 17.4% in the second quarter of 2013, compared to 33.9% in the second quarter of 2012. New business policies written for homeowners increased 11.2% in the second quarter of 2013, compared to 22.1% in the second quarter of 2012. The new business year-over-year average premium per policy for homeowners increased 8.6% at June 30, 2013, compared to 7.7% at June 30, 2012.

Renewal premiums written on personal lines increased 7.5% in the second quarter of 2013, compared to 5.5% in the second 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 June 30, 2013, compared to 2.7% at June 30, 2012. The personal lines year-over-year policy retention ratio was 91.5% at June 30, 2013, 91.6% at December 31, 2012, and 91.4% at June 30, 2012.

Private passenger auto renewal premiums written increased 4.7% in the second quarter of 2013, compared to 2.5% in the second quarter of 2012. The year-over-year average premium per policy on private passenger auto renewal business increased 1.5% at June 30, 2013, compared to 0.5% at June 30, 2012. The private passenger auto year-over-year policy retention ratio was 92.2% at June 30, 2013, 92.1% at December 31, 2012 and 91.7% at June 30, 2012.

Homeowners renewal premiums written increased 12.3% in the second quarter of 2013, compared to 11.1% in the second quarter of 2012. The year-over-year average premium per policy on homeowners renewal business increased 8.9% at June 30, 2013, compared to 8.0% at June 30, 2012. The homeowners year-over-year policyholder retention ratio was 90.6% at June 30, 2013, and 90.9% at December 31, 2012, and 90.8% at June 30, 2012.

Commercial lines – Total commercial lines premiums written increased 10.6% to \$391 million in the second quarter of 2013, from \$353 million in the second quarter of 2012, driven by a 4.6% increase in the total commercial lines policies in force and a 7.1% increase in the total commercial lines year-over-year average premium per policy.

New business premiums written on commercial lines increased 1.2% in the second quarter of 2013, compared to 34.2% in the second 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 auto and commercial multi-peril lines of business. Commercial lines new business policies written increased 1.7% in the second quarter of 2013, compared to 10.1% in the second quarter of 2012, while the year-over-year average premium per policy on commercial lines new business increased 9.8% at June 30, 2013, compared to 11.8% at June 30, 2012.

Renewal premiums for commercial lines increased 12.6% in the second quarter of 2013, compared to an increase of 7.1% in the second 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 and workers compensation lines of business. The year-over-year average premium per policy on commercial lines renewal business increased 6.6% at June 30, 2013, compared



Table of Contents

to 4.0% at June 30, 2012. The year-over-year policy retention ratio for commercial lines was 86.4% at June 30, 2013, 86.2% at December 31, 2012 and 85.9% at June 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 June 30, 2013, we had nearly 2,200 agencies with over 10,500 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 64.8% in the second quarter of 2013, compared to 65.9% in the second quarter of 2012, and was 66.2% for the six months ended June 30, 2013, compared to 65.1% for the six months ended June 30, 2012. The lower ratio for the first six months of 2012 was driven primarily by a lower volume of non-catastrophe, weather related claims resulting from mild winter weather compared to the first six months of 2013.

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 \$45 million in the second quarter of 2013, compared to \$204 million in the second quarter of 2012, and contributed 3.7 points and 18.7 points, respectively, to the loss ratios. Catastrophe losses in the second quarter of 2013 primarily included flooding, hail, ice, snow, tornado and wind storms that occurred in April in the state of Indiana and flooding, hail, and wind storms in April and June which impacted multiple states. Catastrophe losses in the second quarter of 2012 primarily included wind storms that occurred at the end of April in the state of Pennsylvania and at the end of June which impacted multiple states. For the six months ended June 30, 2013, catastrophe losses for the current accident year totaled \$72 million, compared to \$229 million for the six months ended June 30, 2012, and contributed 3.0 points and 10.6 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:

(in millions)	Property and Casualty Group		Six months ended June 30,	
	Three months ended June 30, 2013	2012	2013	2012
	(Unaudited)		(Unaudited)	

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Direct business, including reserves for catastrophe losses and salvage and subrogation	\$20	\$2	\$29	\$(18)	)
Assumed reinsurance business	4	(3	) 3	0	
Ceded reinsurance business	(6	) (4	) (7	) (6	)
Total prior year loss development	\$18	\$(5	) \$25	\$(24	)

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

Direct business, including reserves for catastrophe losses and salvage and subrogation – In the second quarter of 2013, the Property and Casualty Group experienced adverse development on direct prior accident year loss reserves of \$20 million that contributed 1.7 points to the combined ratio, compared \$2 million in the second quarter of 2012 that contributed 0.3 points to

Table of Contents

the combined ratio. For the six months ended June 30, 2013, adverse development of direct prior accident year loss reserves totaled \$29 million and contributed 1.2 points to the combined ratio, compared to favorable development of \$18 million that improved the combined ratio by 0.7 points for the six months ended June 30, 2012.

The adverse development in the first six months of 2013 was primarily related to increased reserves that occurred in the first quarter on two massive injury lifetime medical claims in the workers compensation line of business, combined with adverse development in the commercial multi-peril line of business that occurred in the second quarter. In the first six months of 2012, the favorable development was primarily driven by better than expected severity on liability claims in the homeowners and commercial multi-peril lines of business, offset somewhat by adverse development in the second quarter of 2012 driven primarily by an increase in annual claim cost expectations on massive injury lifetime medical claims in the personal auto line of business and increased severity in the workers compensation line of business.

Assumed reinsurance – The Property and Casualty Group experienced adverse development on prior accident year loss reserves for its assumed reinsurance business totaling \$4 million in the second quarter of 2013, compared to favorable development of \$3 million in the second quarter of 2012. In the first six months of 2013, adverse development on prior accident year loss reserves for the assumed reinsurance business totaled \$3 million, compared to favorable development of \$0.1 million in the first six months of 2012.

Ceded reinsurance – The Property and Casualty Group’s ceded reinsurance reserve recoveries increased by \$6 million and \$4 million in the second quarters of 2013 and 2012, respectively, and by \$7 million and \$6 million in the first six 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 six 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 six 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 1.3 points to 29.1% in the second quarter of 2013, compared to 30.4% in the second quarter of 2012, and decreased 0.6 points to 28.7% for the six months ended June 30, 2013, compared to 29.3% for the six months ended June 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 second quarter and six months ended June 30, 2012 includes an adjustment of \$4 million which contributed 0.4 points and 0.2 points, respectively, to the combined ratios at June 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 June 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 June 30,			Six months ended June 30,				
	2013	2012	% Change	2013	2012	% Change		
	(Unaudited)			(Unaudited)				
Individual life premiums, net of reinsurance	\$20	\$18	10.0	% \$38	\$35	9.1	%	
Group life and other premiums	0	0	2.7	1	1	3.4		
Other revenue	0	0	(9.8	)	1	1	(10.8	)
Total net policy revenue	20	18	9.4	40	37	8.6		
Net investment income	23	24	(0.8	)	46	48	(1.4	)
Net realized gains on investments	3	4	(27.7	)	6	4	13.5	
Impairment losses recognized in earnings	(1	)	0	NM	(1	)	0	NM
Equity in earnings (losses) of limited partnerships	1	0	NM	1	0	NM		
Total revenues	46	46	0.9	92	89	4.2		
Benefits and other changes in policy reserves	26	25	6.0	52	50	5.1		
Amortization of deferred policy acquisition costs	3	4	(4.3	)	6	7	(6.3	)
Other operating expenses	4	4	(6.5	)	10	10	(4.2	)
Total benefits and expenses	33	33	3.1	68	67	2.5		
Income before taxes – Exchange <sup>(1)</sup>	\$13	\$13	(4.4	)	% \$24	\$22	9.1	%

NM = not meaningful

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

## Policy revenue

Gross policy revenues increased 5.2% to \$31 million in the second quarter 2013, from \$29 million in the second 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 \$12 million in the second quarter of 2013, compared to \$11 million in the second quarter of 2012. For the six months ended June 30, 2013, compared to 2012, gross policy revenues totaled \$60 million and \$57 million, respectively, while ceded reinsurance premiums totaled \$21 million for both respective periods.

Premiums received on annuity and universal life products totaled \$20 million in both the second 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 \$16 million in both the second quarters of 2013 and 2012. For the six months ended June 30, 2013, compared to 2012, premiums received on annuity and universal life products totaled \$40 million for both respective periods, while annuity and universal life deposits totaled \$32 million for both respective periods.

## Investment revenue

In the second quarter and first six months of 2013, EFL experienced a decrease and increase, respectively, in net realized gains on investments, primarily due to the second quarter of 2012 having higher gains on the disposal of bonds and the first six months of 2013 having increased call activity on preferred stocks. Also, in the second quarter and first six months of 2013, equity in earnings of limited partnerships increased, while net investment income decreased due to lower investment yields and impairment losses recognized in earnings increased due to a bond impairment. See the discussion of investments in the “Investment Operations” segment that follows for further information.

#### Benefits and expenses

Benefits and other changes in policy reserves increased in the second quarter and first six months of 2013, impacted by an increase in death benefits and future policy benefits compared to the second quarter and first six months of 2012. Offsetting these increases was a slight decrease in the amortization of deferred policy acquisition costs in the second quarter and first six months of 2013.

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					
	Three months ended June 30,			Six months ended June 30,		
	2013	2012	% Change	2013	2012	% Change
	(Unaudited)			(Unaudited)		
Indemnity						
Net investment income	\$3	\$4	(21.3 )%	\$7	\$8	(15.4 )%
Net realized gains (losses) on investments	0	(1 )	NM	0	2	NM
Net impairment losses recognized in earnings	0	0	NM	0	0	NM
Equity in earnings of limited partnerships	5	3	59.3	8	4	84.6
Net revenue from investment operations – Indemnity	\$8	\$6	51.1 %	\$15	\$14	7.7 %
Exchange						
Net investment income	\$104	\$111	(6.3 )%	\$206	\$218	(5.4 )%
Net realized gains (losses) on investments	61	(106 )	NM	310	187	65.1
Net impairment losses recognized in earnings	(1 )	0	NM	(1 )	0	NM
Equity in earnings of limited partnerships	34	34	(0.2 )	67	54	24.0
Net revenue from investment operations – Exchange <sup>(1)</sup>	\$198	\$39	NM	\$582	\$459	26.7 %

NM = not meaningful

The Exchange's investment results for the second quarter of 2013 and 2012 include net investment revenues from (1) EFL's operations of \$26 million and \$28 million, respectively. The Exchange's investment results for the first six months of 2013 and 2012 both include net investment revenues from EFL's operations of \$52 million.

## 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 decreased \$1 million in the second quarter of 2013, compared to the second quarter of 2012, while the Exchange's net investment income decreased \$7 million.

Indemnity's net investment income decreased \$1 million for the six months ended June 30, 2013, compared to the six months ended June 30, 2012, while the Exchange's net investment income decreased \$12 million. The decrease in net investment income for Indemnity in both periods 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 \$0.2 million in the second quarter of 2013, compared to losses of \$1 million in the second quarter of 2012, while the Exchange generated net realized gains of \$61 million, compared to losses of \$106 million. Indemnity generated net realized gains of \$0.2 million for the six months ended June 30, 2013, compared to gains of \$2 million for the six months ended June 30, 2012, while the Exchange generated net realized gains of \$310 million, compared to gains of \$187 million.

Indemnity recorded no changes in the fair value of common stocks in the second quarter or the six months ended June 30, 2013, due to the sale of its common stock portfolio classified as trading securities in the fourth quarter of 2012.

Net realized losses for Indemnity in the second quarter of 2012 primarily represented decreases in the fair value of common stocks, while net realized gains for the six months ended June 30, 2012 were primarily due to gains on the sales of common stock and increases in the fair value of common stocks. Net realized gains for the Exchange increased in the second quarter of 2013, primarily due to realized gains from the sales of common stock, compared to decreases in the fair value of common stocks recorded in the second quarter of 2012. Net realized gains for the Exchange increased for the six months ended June 30, 2013 due to experiencing higher net realized gains on common stocks and increases in the fair value of common stocks, compared to the six months ended June 30, 2012.

Net impairment losses recognized in earnings

Net impairment losses recorded in earnings for Indemnity for the second quarter and six months ended June 30, 2013 were \$0.1 million, compared to no net impairment losses for the second quarter and six months ended June 30, 2012. Net impairment losses for the Exchange were \$1 million for the second quarter and six months ended June 30, 2013, compared to no net impairment losses for the second quarter of 2012, and \$0.1 million for the six months ended June 30, 2012.

Table of Contents

## Equity in earnings of limited partnerships

Indemnity's equity in earnings of limited partnerships increased \$2 million in the second quarter of 2013, compared to the second quarter of 2012, while the Exchange's equity in earnings of limited partnerships was unchanged.

Indemnity's equity in earnings of limited partnerships increased \$4 million for the six months ended June 30 2013, compared to the six months ended June 30, 2012, while the Exchange's equity in earnings of limited partnerships increased \$13 million. The increase in earnings for Indemnity during the second quarter of 2013 was primarily due to higher earnings from private equity investments, while earnings for the Exchange were unchanged, as higher earnings from private equity were offset by lower earnings from mezzanine debt and real estate investments. For the six months ended June 30, 2013, the increase in earnings for both 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		Six months ended June 30,	
	Three months ended June 30, 2013 (Unaudited)	2012	2013 (Unaudited)	2012
Indemnity				
Securities sold:				
Fixed maturities	\$0	\$0	\$0	\$0
Preferred stock equity securities	0	0	0	0
Common stock equity securities	0	0	0	1
Common stock increases (decreases) in fair value <sup>(1)</sup>	0	(1	) 0	1
Total net realized gains (losses) – Indemnity <sup>(2)</sup>	\$0	\$(1	) \$0	\$2
Exchange				
Securities sold:				
Fixed maturities	\$4	\$13	\$17	\$19
Preferred stock equity securities	2	2	4	3
Common stock equity securities	51	23	141	52
Common stock increases (decreases) in fair value <sup>(1)</sup>	4	(144	) 148	113
Total net realized gains (losses) – Exchange <sup>(2) (3)</sup>	\$61	\$(106	) \$310	\$187

(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 the second quarter of 2013 and 2012 include net realized gains from EFL's operations of \$3 million and \$4 million, respectively. The Exchange's results for the first six months of 2013 and 2012 include net realized gains from EFL's operations of \$6 million and \$4 million, respectively.

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

(in millions)	Erie Insurance Group		Six months ended June 30,	
	Three months ended June 30, 2013 (Unaudited)	2012	2013 (Unaudited)	2012
Indemnity				
Private equity	\$3	\$1	\$2	\$2



Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Mezzanine debt	0	1	1	3	
Real estate	2	1	5	(1	)
Total equity in earnings of limited partnerships – Indemnity	\$5	\$3	\$8	\$4	
Exchange					
Private equity	\$22	\$14	\$32	\$28	
Mezzanine debt	5	7	12	17	
Real estate	7	13	23	9	
Total equity in earnings of limited partnerships – Exchange <sup>(1)</sup>	\$34	\$34	\$67	\$54	

- (1) The Exchange's results for the second quarter of 2013 and 2012 include equity in earnings of limited partnerships from EFL's operations of \$0.5 million and \$0.2 million, respectively. The Exchange's results for the first six months of 2013 and 2012 include equity in earnings of limited partnerships from EFL's operations of \$0.9 million and losses of \$(0.2) million, 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 June 30, 2013 reflect investment valuation changes resulting from the financial markets and the economy in the first quarter of 2013.

55

---

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.

## Distribution of investments

(in millions)	Erie Insurance Group Carrying value at		Carrying value at		
	June 30, 2013 (Unaudited)	% to total	December 31, 2012	% to total	
Indemnity					
Fixed maturities	\$438	67	% \$452	66	%
Equity securities:					
Preferred stock	23	3	29	4	
Common stock	25	4	26	4	
Limited partnerships:					
Private equity	67	10	73	11	
Mezzanine debt	23	4	27	4	
Real estate	76	12	80	11	
Real estate mortgage loans	1	0	1	0	
Total investments – Indemnity	\$653	100	% \$688	100	%
Exchange					
Fixed maturities	\$7,725	62	% \$7,707	64	%
Equity securities:					
Preferred stock	647	5	631	5	
Common stock	3,046	24	2,731	22	
Limited partnerships:					
Private equity	474	4	482	4	
Mezzanine debt	187	2	196	2	
Real estate	350	3	359	3	
Life policy loans	17	0	16	0	
Real estate mortgage loans	3	0	4	0	
Total investments – Exchange	\$12,449	100	% \$12,126	100	%
Total investments – Erie Insurance Group	\$13,102		\$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 \$179 million, or 41%, of the total fixed maturity portfolio for Indemnity and \$1.3 billion, or 16%, of the fixed maturity portfolio for the Exchange at June 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 \$5 million at June 30, 2013, compared to \$10 million at December 31, 2012. At June 30, 2013, the Exchange had net unrealized gains on fixed maturities of \$237 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 June 30, 2013 (Unaudited)					Fair value
	AAA	AA	A	BBB	Non- investment grade	
Industry Sector						
Indemnity						
Basic materials	\$0	\$0	\$0	\$11	\$0	\$11
Communications	0	0	15	5	0	20
Consumer	0	0	19	27	0	46
Energy	0	0	10	19	0	29
Financial	0	33	44	40	6	123
Government-municipal	81	60	33	5	0	179
Industrial	0	0	1	7	0	8
Structured securities <sup>(2)</sup>	0	0	0	1	0	1
Technology	0	0	0	9	0	9
Utilities	0	0	3	9	0	12
Total – Indemnity	\$81	\$93	\$125	\$133	\$6	\$438
Exchange						
Basic materials	\$0	\$0	\$56	\$168	\$15	\$239
Communications	0	0	208	319	14	541
Consumer	0	26	296	605	22	949
Diversified	0	0	15	0	0	15
Energy	15	54	146	405	14	634
Financial	1	150	1,102	1,082	171	2,506
Foreign government	0	10	13	0	0	23
Government-municipal	379	737	131	27	0	1,274
Government sponsored entity	0	37	0	0	0	37
Industrial	0	10	56	231	15	312
Structured securities <sup>(2)</sup>	37	253	46	23	2	361
Technology	0	28	51	88	0	167
U.S. Treasury	0	147	0	0	0	147
Utilities	0	0	92	408	20	520

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Total – Exchange	\$432	\$1,452	\$2,212	\$3,356	\$273	\$7,725
------------------	-------	---------	---------	---------	-------	---------

(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.

57

---

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	
	June 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	15	0	15	0
Funds <sup>(1)</sup>	0	25	0	26
Utilities	4	0	10	0
Total – Indemnity	\$23	\$25	\$29	\$26
Exchange				
Basic materials	\$0	\$80	\$0	\$94
Communications	10	277	10	190
Consumer	6	841	5	765
Diversified	2	15	2	21
Energy	0	184	0	177
Financial	522	449	495	423
Funds <sup>(1)</sup>	0	571	0	436
Government	1	0	1	0
Industrial	7	393	0	390
Technology	0	199	0	197
Utilities	99	37	118	38
Total – Exchange	\$647	\$3,046	\$631	\$2,731

Includes certain exchange traded funds with underlying holdings of fixed maturity securities totaling \$25 million for Indemnity and \$322 million for the Exchange at June 30, 2013, and \$26 million for Indemnity and \$314 million (1) 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. At June 30, 2013, the unrealized gain on equity securities classified as available-for-sale, net of deferred taxes, amounted to \$0.4 million for Indemnity and \$35 million for the Exchange, compared to \$1 million for Indemnity and \$48 million for the Exchange 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.

58

---



Table of Contents

## Limited partnerships

In the second 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 second quarter of 2013 reflect the partnership activity experienced in the first quarter of 2013.

The components of limited partnership investments are as follows:

(in millions)	Erie Insurance Group	
	At June 30, 2013 (Unaudited)	At December 31, 2012
Indemnity		
Private equity	\$67	\$73
Mezzanine debt	23	27
Real estate	76	80
Total limited partnerships – Indemnity	\$166	\$180
Exchange		
Private equity	\$474	\$482
Mezzanine debt	187	196
Real estate	350	359
Total limited partnerships – Exchange	\$1,011	\$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 June 30, 2013	At December 31, 2012
	(Unaudited)	
Gross reserve liability <sup>(1)</sup> :		
Personal auto	\$1,165	\$1,169
Automobile massive injury	351	351
Homeowners	299	299
Workers compensation	555	512
Workers compensation massive injury	95	99
Commercial auto	353	340
Commercial multi-peril	574	557
All other lines of business	172	166
Assumed reinsurance	104	105
Gross reserves	3,668	3,598
Reinsurance recoverable	159	154
Net reserve liability — Exchange	\$3,509	\$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 \$83 million at June 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 111 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 \$297 million at June 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. The slight decrease in the workers compensation massive injury reserves at June 30, 2013, compared to December 31, 2012, was primarily due to claimant aging and a decline in the annual cost of claimant care.

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.

60

---

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 six months ended June 30:

(in millions)	Erie Insurance Group	
	2013	2012
Net cash provided by operating activities	\$330	\$191
Net cash used in investing activities	(335)	(57)
Net cash used in financing activities	(30)	(79)
Net (decrease) increase in cash and cash equivalents	\$(35)	\$55

Net cash provided by operating activities totaled \$330 million and \$191 million for the first six months of 2013 and 2012, respectively. Increased cash from operating activities for the first six 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, and an increase in limited partnership distributions received. Offsetting this increase in cash somewhat were increases in losses and loss expenses paid and other underwriting and acquisition costs paid, and a slight decline in net investment income received compared to the first six months of 2012.

At June 30, 2013, we recorded a net deferred tax asset of \$43 million attributable to Indemnity and a net deferred tax liability of \$312 million attributable to the Exchange. There was no deferred tax valuation allowance recorded at June 30, 2013. Our

Table of Contents

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 \$335 million and \$57 million for the first six months of 2013 and 2012, respectively. The first six months of 2013, investing activities primarily included increased cash used to purchase certain fixed maturity securities and common stocks, offset somewhat by increased cash generated from the sale of other common stocks and fixed maturity securities, compared to the first six months of 2012. At June 30, 2013, we had contractual commitments to invest up to \$423 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 \$156 million, mezzanine debt securities was \$173 million, and real estate activities was \$94 million.

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

## Cash flow activities — Indemnity

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

(in millions)	Indemnity Shareholder Interest	
	2013	2012
Net cash provided by operating activities	\$57	\$66
Net cash provided by investing activities	15	33
Net cash used in financing activities	(45	) (97
Net increase in cash and cash equivalents	\$27	\$2

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 \$57 million for the first six months of 2013, compared to \$66 million for the first six months of 2012. The slight decrease in cash from operating activities for the first six months of 2013 was primarily due to increases in commissions paid to agents, general operating expenses paid, cash paid for salaries and wages, and income taxes paid. Offsetting this decrease in cash were increases in management fee revenue received and limited partnership distributions, compared to the first six 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 \$356 million in the first six months of 2013, compared to \$320 million for the first six 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 June 30, 2013, Indemnity recorded a net deferred tax asset of \$43 million. There was no deferred tax valuation allowance recorded at June 30, 2013.

Net cash provided by Indemnity's investing activities totaled \$15 million for the first six months of 2013, compared to \$33 million for the first six months of 2012. Indemnity's first six months of 2013 investing activities primarily

included decreased cash generated from the sales of fixed maturity securities and common stocks, offset somewhat by a slight decrease in cash generated from the sales of preferred stocks compared to the first six months of 2012. Also impacting Indemnity's future investing activities are limited partnership commitments, which totaled \$30 million at June 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 \$45 million for the first six months of 2013, compared to \$97 million for the first six months of 2012. The decrease in cash used in financing activities for the first six months of 2013 was driven by a decrease in the cash outlay for dividends paid to shareholders and share repurchases. Dividends paid to shareholders totaled

## Table of Contents

\$28 million for the first six months of 2013, compared to \$53 million for the first six 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 six months of 2012. In the first six 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.

Indemnity repurchased 23,798 shares of its Class A nonvoting common stock in conjunction with its stock repurchase program at a total cost of \$1 million, based upon settlement date, in the second quarter of 2013. During the first six months of 2013, shares repurchased under this program totaled 0.2 million at a total cost of \$16 million. In the first six months of 2012, shares repurchased under this program totaled 0.6 million at a total cost of \$44 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 \$53 million of repurchase authority remaining under this program at June 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.

### 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 \$39 million at June 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 \$369 million at June 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.

Indemnity had no borrowings under its line of credit at June 30, 2013. At June 30, 2013, bonds with fair values of \$111 million were pledged as collateral. 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 June 30, 2013.

### 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 \$326 million at June 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 \$10.8 billion at June 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.

The Exchange had no borrowings under its line of credit at June 30, 2013. At June 30, 2013, bonds with fair values of \$331 million were pledged as collateral. 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 June 30, 2013.

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.

Table of Contents

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 six months ended June 30, 2013 and 2012, Indemnity recognized interest income on the note of \$0.8 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 six months ended June 30, 2013 and 2012, the Exchange recognized interest income on the note of \$0.6 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 six months ended June 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 six months ended June 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 “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. Indemnity has opposed the Petition and has asked the state court to stay all further proceedings pending the resolution of the Beltz lawsuit (described below). A decision on this Petition has not yet been rendered.

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, but 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 situated 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. Vorsheck; 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, but a decision has not yet been rendered.

The Directors have advised Indemnity that they intend to vigorously defend against the claims in the Beltz lawsuit and 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 June 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
	April 1 – 30, 2013	6,110	\$74.75	6,110	\$54
	May 1 – 31, 2013	3,958	74.40	3,958	54
	June 1 – 30, 2013	16,763	74.22	13,730	53
	Total	26,831		23,798	

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.

The month of June 2013 includes repurchases of 3,033 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$224,527 or \$74.03 per share, to settle a payment due to a retired executive under our long-term incentive plan. These shares were delivered to the plan participant in July 2013.

Table of Contents

## ITEM 6. EXHIBITS

Exhibit Number	Description of Exhibit
10.1	Erie Indemnity Company Equity Compensation Plan (incorporated by reference to Appendix A to the Registrant's Information Statement for the 2013 Annual Meeting of Shareholders filed with the Commission on March 18, 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

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: August 1, 2013

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

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