ERIE INDEMNITY CO
Form 10-Q
August 01, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PERSUANT 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 X 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 X 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 X 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 X Accelerated Filer ___ Non-Accelerated Filer ___ Smaller Reporting Company ___

(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.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

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

	Three months ended June 30, 2013	Three months ended June 30, 2012	Six months ended June 30, 2013	Six months ended June 30, 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

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.

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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.

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

Assets	June 30, 2013 (Unaudited)	December 31, 2012
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

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.

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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.

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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.

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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.

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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

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

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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.

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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.

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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					
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations	Eliminations	Consolidated
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					
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations	Eliminations	Consolidated
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

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	—	(70)
Provision for income taxes	21	(55)	(6)	8	—	(32)
Net income (loss)	$38	$(104)	$(9)	$37	$—	$ (38)

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(in millions)	Erie Insurance Group Six months ended June 30, 2013					
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations	Eliminations	Consolidated
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					
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations	Eliminations	Consolidated
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

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

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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.

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

	Erie Insurance Group June 30, 2013 Fair value measurements using:			
(in millions)	Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
Indemnity				
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 (1)	20	0	0	20
Total – Indemnity	$506	$27	$457	$22
Exchange				
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 (1)	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.

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Level 3 Assets – Quarterly Change:

(in millions)	Erie Insurance Group 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)	Ending balance at June 30, 2013
Indemnity							
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
Exchange							
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

(1) These amounts are reported in the Consolidated Statement of Operations. There is $3 million included in net 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.

(2) Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for 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.

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Level 3 Assets – Year-to-Date Change:

	Erie Insurance Group						
(in millions)	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]	Ending balance at June 30, 2013
Indemnity							
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
Exchange							
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

(1) These amounts are reported in the Consolidated Statement of Operations. There is $(2) million included in net 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.

(2) Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for 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.

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Quantitative and Qualitative Disclosures about Unobservable Inputs

(dollars in millions)	Erie Insurance Group June 30, 2013 Fair value	No. of holdings	Valuation techniques	Unobservable input	Range	Weighted average
Indemnity						
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				
Exchange						
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.

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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.

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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
Indemnity				
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 [(1)]	19	0	0	19
Total – Indemnity	$526	$ 30	$473	$ 23
Exchange				
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 [(1)]	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.

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Level 3 Assets – Quarterly Change:

	Erie Insurance Group						
(in millions)	Beginning balance at March 31, 2012	Included in earnings (1)	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3 (2)	Ending balance at June 30, 2012
Indemnity							
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 (3)	17	1	0	0			