

ERIE INDEMNITY CO  
Form 10-K  
February 27, 2012  
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

**FORM 10-K**

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

For the fiscal year ended December 31, 2011

OR

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

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)

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

Class A common stock, stated value \$0.0292 per share, listed on the NASDAQ Stock Market, LLC  
(Title of each class) (Name of each exchange on which registered)

**Securities registered pursuant to Section 12(g) of the Act:** None

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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   
(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

Aggregate market value of voting and non-voting common stock held by non-affiliates as of the last business day of the registrant's most recently completed second fiscal quarter: \$1.9 billion of Class A non-voting common stock as of June 30, 2011. There is no active market for the Class B voting common stock. The Class B common stock is closely held by few shareholders.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

47,741,429 shares of Class A common stock and 2,545 shares of Class B common stock outstanding on February 17, 2012.

**DOCUMENTS INCORPORATED BY REFERENCE**

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Portions of Part III of this Form 10-K (Items 10, 11, 12, 13, and 14) are incorporated by reference to the information statement on Form 14(C) to be filed with the Securities and Exchange Commission no later than 120 days after December 31, 2011.

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Table of ContentsINDEX

<u>PART</u>	<u>ITEM NUMBER AND CAPTION</u>	<u>PAGE</u>		
I	<u>Item 1.</u>	<u>Business</u>	3	
	<u>Item 1A.</u>	<u>Risk Factors</u>	9	
	<u>Item 1B.</u>	<u>Unresolved Staff Comments</u>	18	
	<u>Item 2.</u>	<u>Properties</u>	18	
	<u>Item 3.</u>	<u>Legal Proceedings</u>	18	
	<u>Item 4.</u>	<u>Removed and Reserved</u>	18	
II	<u>Item 5.</u>	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	19	
	<u>Item 6.</u>	<u>Selected Consolidated Financial Data</u>	21	
	<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22	
	<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	64	
	<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	68	
	<u>Item 9.</u>	<u>Changes In and Disagreements With Accountants on Accounting and Financial Disclosure</u>	125	
	<u>Item 9A.</u>	<u>Controls and Procedures</u>	125	
	<u>Item 9B.</u>	<u>Other Information</u>	125	
	III	<u>Item 10.</u>	<u>Directors, Executive Officers and Corporate Governance</u>	126
		<u>Item 11.</u>	<u>Executive Compensation</u>	127
<u>Item 12.</u>		<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	127	
<u>Item 13.</u>		<u>Certain Relationships and Related Transactions, and Director Independence</u>	127	
<u>Item 14.</u>		<u>Principal Accountant Fees and Services</u>	127	
IV	<u>Item 15.</u>	<u>Exhibits and Financial Statement Schedules</u>	128	
		<u>Signatures</u>	129	

Table of Contents

**PART I**

**ITEM 1. BUSINESS**

**General**

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.

Through December 31, 2010, Indemnity also operated as a property and casualty insurer through its wholly owned subsidiaries, Erie Insurance Company ( EIC ), Erie Insurance Company of New York ( ENY ) and Erie Insurance Property and Casualty Company ( EPC ). EIC, ENY and EPC, together with the Exchange and its wholly owned subsidiary, Flagship City Insurance Company ( Flagship ), 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 and writes primarily private passenger automobile, homeowners, commercial multi-peril, commercial automobile and workers compensation lines of insurance. On December 31, 2010, Indemnity sold all of the outstanding capital stock of its wholly owned property and casualty insurance subsidiaries to the Exchange.

Erie Family Life Insurance Company ( EFL ) is an affiliated life insurance company that underwrites and sells individual and group life insurance policies and fixed annuities. On March 31, 2011, Indemnity sold its 21.6% ownership interest in EFL to the Exchange. There was no gain or loss resulting from this sale as Indemnity is the primary decision maker for the Exchange.

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 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).

**Business Segments**

We operate our business as four reportable segments management operations, property and casualty insurance operations, life insurance operations and investment operations. Financial information about these segments is set forth in and referenced to Item 8. Financial Statements and Supplementary Data - Note 5, Segment Information, of Notes to Consolidated Financial Statements contained within this report. Further discussion of financial results by operating segment is provided in and referenced to Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations contained within this report.

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### Table of Contents

**Management operations** We generate internal management fee revenue, which accrues to the Indemnity shareholder interest, as Indemnity provides services to the Exchange relating to the sales, underwriting and issuance of policies. The Exchange is the sole customer of our management operations. Indemnity charges the Exchange a management fee, determined by our Board of Directors, not to exceed 25% of all premiums written or assumed by the Exchange for its services as attorney-in-fact. Management fee revenue is eliminated upon consolidation.

**Property and casualty insurance operations** The Property and Casualty Group generates revenue by insuring preferred and standard risks, with personal lines comprising 73% of the 2011 direct written premiums and commercial lines comprising the remaining 27%. The principal personal lines products based upon 2011 direct written premiums were private passenger automobile (47%) and homeowners (22%). The principal commercial lines products based upon 2011 direct written premiums were commercial multi-peril (12%), commercial automobile (7%) and workers compensation (7%).

The 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. Prior to December 31, 2010, the underwriting results retained by EIC and ENY accrued to the Indemnity shareholder interest. Due to the sale of Indemnity's property and casualty insurance subsidiaries to the Exchange on December 31, 2010, all property and casualty underwriting results accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after December 31, 2010.

Historically, due to policy renewal and sales patterns, the Property and Casualty Group's direct written premiums are greater in the second and third quarters than in the first and fourth quarters of the calendar year. Property and casualty insurance premiums earned accounted for approximately 86% of our total consolidated revenue in 2011, 81% in 2010 and 90% in 2009.

The Property and Casualty Group is represented by over 2,100 independent agencies comprising almost 9,500 licensed property and casualty representatives, which is our sole distribution channel. In addition to their principal role as salespersons, the independent agents play a significant role as underwriting and service providers and are fundamental to the Property and Casualty Group's success.

The Property and Casualty Group writes business in Illinois, Indiana, Maryland, New York, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia, Wisconsin and the District of Columbia. The states of Pennsylvania, Maryland and Virginia made up 63% of the Property and Casualty Group's direct written premium in 2011.

While sales, underwriting and policy issuance services are centralized at our home office, the Property and Casualty Group maintains 24 field offices throughout its operating region to provide claims services to policyholders and marketing support for the independent agencies that represent us.

The Property and Casualty Group ranked as the 12th largest automobile insurer in the United States based upon 2010 direct premiums written and as the 20th largest property and casualty insurer in the United States based upon 2010 total lines net premiums written according to AM Best Company.

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Life insurance operations Our life insurance operations generate revenue from the sale of individual and group life insurance policies and fixed annuities. These products are offered through our property and casualty insurance agency force to provide an opportunity to cross-sell both personal and commercial accounts. EFL writes business in 10 states including Illinois, Indiana, Maryland, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia, and Wisconsin and the District of Columbia. The state of Pennsylvania made up 48% of EFL's 2011 premium and annuity considerations, with Virginia, Maryland and Ohio making up approximately 10% each.

Prior to and through March 31, 2011, Indemnity retained a 21.6% ownership interest in EFL, which accrued to the Indemnity shareholder interest, and the Exchange retained a 78.4% ownership interest in EFL, which accrued to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest. Due to the sale of Indemnity's 21.6% ownership interest in EFL to the Exchange on March 31, 2011, 100% of EFL's life insurance results accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after March 31, 2011.



Table of Contents

***Investment operations*** Our investment operations generate revenue from our fixed maturity, equity security and alternative investment portfolios. The portfolios are managed with the objective of maximizing after-tax returns on a risk-adjusted basis. Revenues and losses included in investment operations consist of net investment income, net realized gains and losses, net impairment losses recognized in earnings for our fixed maturity and preferred equity portfolios, and equity in earnings and losses from our alternative investments, which include private equity, mezzanine debt, and real estate limited partnerships. The volatility inherent in the financial markets has the potential to impact our investment portfolio from time-to-time. Net revenues from our investment operations accounted for approximately 12% of our total consolidated revenue in 2011, 17% in 2010, and 8% in 2009.

**Competition**

Property and casualty insurers generally compete on the basis of customer service, price, consumer recognition, coverages offered, claims handling, financial stability and geographic coverage. Vigorous competition, particularly in the personal lines automobile and homeowners lines of business, is provided by large, well-capitalized national companies, some of which have broad distribution networks of employed or captive agents, by smaller regional insurers, and by large companies who market and sell personal lines products directly to consumers. In addition, because the insurance products of the Property and Casualty Group are marketed exclusively through independent insurance agents, the Property and Casualty Group faces competition within its appointed agencies based upon ease of doing business, product, price and service relationships.

Market competition bears directly on the price charged for insurance products and services subject to regulatory limitations. Growth is driven by a company's ability to provide insurance services and competitive prices while maintaining target profit margins. Industry capital levels can also significantly affect prices charged for coverage. Growth is a product of a company's ability to retain existing customers and to attract new customers, as well as movement in the average premium per policy.

The Erie Insurance Group has a strategic focus that we believe will result in long-term underwriting performance. First, we employ an underwriting philosophy and product mix targeted to produce a Property and Casualty Group underwriting profit on a long-term basis through careful risk selection and rational pricing. The careful selection of risk allows for lower claims frequency and loss severity, thereby enabling insurance to be offered at favorable prices. The Property and Casualty Group has continued to refine its risk measurement and price sophistication models used in the underwriting and pricing processes. Second, the Property and Casualty Group focuses on consistently providing superior service to policyholders and agents. Third, the Property and Casualty Group's business model is designed to provide the advantages of localized marketing and claims servicing with the economies of scale and low cost of operations from centralized accounting, administrative, underwriting, investment, information management and other support services.

Finally, we carefully select the independent agencies that represent the Property and Casualty Group. The Property and Casualty Group seeks to be the lead insurer with its agents in order to enhance the agency relationship and the likelihood of receiving the most desirable underwriting opportunities from its agents. We have ongoing, direct communications with our agency force. Agents have access to a number of venues we sponsor designed to promote the sharing of ideas, concerns and suggestions with the senior management of the Property and Casualty Group, with the goal of improving communications and service. We continually evaluate new ways to support our agents' efforts, from marketing programs to identifying potential customer leads, to grow the business of the Property and Casualty Group and sustain our long-term agency relationships. High agency penetration and long-term relationships allow for greater efficiency in providing agency support and training.

EFL, our life insurer, is subject to many of the same structural advantages and environmental challenges as the Property and Casualty Group. Term life business accounts for the majority of policies issued by EFL, and this product line is extremely competitive and increasingly transparent due in part to the proliferation of on-line quoting services. Besides price, ease of application and processing improvements represent areas where companies are finding ways to differentiate themselves among independent producers. EFL continues to progress in these areas using state-of-the-art technology and third-party vendors. Historically, sound underwriting and disciplined approaches to pricing and investing

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have contributed to favorable operating results. While EFL will be challenged to maintain these trends in the face of intensified competition going forward, we continually shape our strategy and core processes to respond more effectively to the needs of our policyholders and independent agents.

Table of Contents**Employees**

We employed approximately 4,300 full-time people at December 31, 2011.

**Reserves for Property and Casualty Losses and Loss Expenses**

Loss reserves are established to account for the estimated ultimate costs of loss 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 are: 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. A discussion of our property and casualty loss reserve methodology can be found in and is referenced to Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates contained within this report.

Loss and loss expense reserves are presented on our Consolidated Statements of Financial Position on a gross basis.

The table that follows provides a reconciliation of our loss and loss expense reserve beginning and ending balances established for the Property and Casualty Group for the years ended December 31:

<i>(in millions)</i>	2011	Property and Casualty Group 2010	2009
Losses and loss expense reserves at January 1, Gross	\$3,584	\$3,598	\$3,586
Less: reinsurance recoverable	188	200	187
Losses and loss expense reserves at January 1, Net	3,396	3,398	3,399
Incurring losses and loss expenses related to:			
Current accident year	3,616	3,053	2,732
Prior accident years	(272)	(244)	(93)
Total incurred losses and loss expenses	3,344	2,809	2,639
Paid losses and loss expenses related to:			
Current accident year	2,360	1,855	1,608
Prior accident years	1,032	956	1,032
Total paid losses and loss expenses	3,392	2,811	2,640
Losses and loss expense reserves at December 31, Net	3,348	3,396	3,398
Add: reinsurance recoverable	151	188	200
Losses and loss expense reserves at December 31, Gross	\$3,499	\$3,584	\$3,598

The Property and Casualty Group estimates loss reserves at full expected cost except for workers compensation loss reserves, which are discounted on a nontabular basis as prescribed by the Insurance Department of the Commonwealth of Pennsylvania. An interest rate of 2.5% is used to discount these reserves based upon the Property and Casualty Group's historical workers compensation payout patterns. Loss and loss expense reserves were reduced by \$84 million, \$127 million and \$136 million at December 31, 2011, 2010 and 2009, respectively, as a result of this discounting.

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The Property and Casualty Group's reserves for losses and loss expenses are reported net of receivables for salvage and subrogation which totaled \$145 million, \$141 million and \$133 million at December 31, 2011, 2010 and 2009, respectively.

Additional discussions of our property and casualty loss reserve activity can be found in and is referenced to Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations, Property and Casualty Insurance Operations and Financial Condition sections contained within this report.

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### Table of Contents

The following table illustrates the change over time of our loss and loss expense reserve estimates established for the Property and Casualty Group at the end of the last ten calendar years:

		Property and Casualty Group Reserves for Unpaid Losses and Loss Expenses								
<i>(in millions)</i>		At December 31,								
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Gross liability for unpaid losses and loss expenses (LAE)	\$2,940	\$3,401	\$3,629	\$3,779	\$3,830	\$3,684	\$3,586	\$3,598	\$3,584	\$3,499
<i>Gross liability re-estimated as of:</i>										
One year later	2,986	3,360	3,592	3,651	3,559	3,487	3,502	3,336	<u>3,282</u>	
Two years later	3,021	3,423	3,583	3,508	3,467	3,409	3,320	<u>3,068</u>		
Three years later	3,117	3,482	3,558	3,464	3,412	3,307	<u>3,101</u>			
Four years later	3,190	3,497	3,516	3,437	3,358	<u>3,111</u>				
Five years later	3,223	3,466	3,494	3,404	<u>3,174</u>					
Six years later	3,173	3,440	3,485	<u>3,224</u>						
Seven years later	3,186	3,430	<u>3,313</u>							
Eight years later	3,189	<u>3,275</u>								
Nine years later	<u>3,036</u>									
Cumulative (deficiency) redundancy	\$ (96)	\$ 126	\$ 316	\$ 555	\$ 656	\$ 573	\$ 485	\$ 530	\$ 302	N/A
Gross liability for unpaid losses and LAE	\$2,940	\$3,401	\$3,629	\$3,779	\$3,830	\$3,684	\$3,586	\$3,598	\$3,584	\$3,499
Reinsurance recoverable on unpaid losses(1)	<u>119</u>	<u>124</u>	<u>133</u>	<u>155</u>	<u>183</u>	<u>190</u>	<u>187</u>	<u>200</u>	<u>188</u>	<u>151</u>
Net liability for unpaid losses and LAE	\$2,821	\$3,277	\$3,496	\$3,624	\$3,647	\$3,494	\$3,399	\$3,398	\$3,396	\$3,348
<i>Cumulative amount of gross liability paid through:</i>										
One year later	\$ 933	\$1,055	\$1,066	\$1,067	\$1,019	\$1,042	\$1,033	\$ 955	<u>\$1,042</u>	
Two years later	1,477	1,638	1,699	1,630	1,621	1,573	1,538	<u>1,474</u>		
Three years later	1,819	2,034	2,056	2,016	1,962	1,889	<u>1,862</u>			
Four years later	2,044	2,245	2,294	2,235	2,147	<u>2,079</u>				
Five years later	2,161	2,394	2,431	2,342	<u>2,270</u>					
Six years later	2,256	2,484	2,509	<u>2,427</u>						
Seven years later	2,316	2,541	<u>2,573</u>							
Eight years later	2,357	<u>2,588</u>								
Nine years later	<u>2,397</u>									

(1) Reinsurance recoverable on unpaid losses represents the related ceded amounts.

### **Government Regulation**

Property and casualty insurers are subject to supervision and regulation in the states in which they transact business. The extent of such regulation varies, but generally derives from state statutes that delegate regulatory, supervisory and administrative authority to state insurance departments. Accordingly, the authority of the state insurance departments includes the establishment of standards of solvency that must be met and maintained by insurers, the licensing to do business of insurers and agents, the nature of the limitations on investments, the approval of premium rates for property and casualty insurance, the provisions that insurers must make for current losses and future liabilities, the deposit of

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securities for the benefit of policyholders, the approval of policy forms, notice requirements for the cancellation of policies and the approval of certain changes in control. In addition, many states have enacted variations of competitive rate-making laws that allow insurers to set certain premium rates for certain classes of insurance without having to obtain the prior approval of the state insurance department. State insurance departments also conduct periodic examinations of the affairs of insurance companies and require the filing of quarterly and annual reports relating to the financial condition of insurance companies.

The Property and Casualty Group is also required to participate in various involuntary insurance programs for automobile insurance, as well as other property and casualty lines, in states in which these companies operate. These involuntary programs provide various insurance coverages to individuals or other entities that are otherwise unable to purchase such coverages in the voluntary market. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements ( FAIR ) plans, reinsurance facilities and windstorm plans.

Table of Contents

Legislation establishing these programs generally provides for participation in proportion to voluntary writings of related lines of business in that state. The loss ratio on insurance written under involuntary programs has traditionally been greater than the loss ratio on insurance in the voluntary market. Although currently the federal government does not directly regulate the insurance industry, federal programs, such as federal terrorism backstop legislation and the Federal Insurance Office established under the Dodd-Frank Act can also impact the insurance industry.

Our life insurer, EFL, is subject to similar state regulations as the Property and Casualty Group, although specific laws and statutes applicable to life insurance and annuity carriers govern its activities. Valuation laws require statutory reserves to be held at conservative levels, which can have a substantial impact on the amount of free surplus that is available for financing new business and other growth opportunities.

Most states have enacted legislation that regulates insurance holding company systems such as the Erie Insurance Group. Each insurance company in the holding company system is required to register with the insurance supervisory authority of its state of domicile and furnish information regarding the operations of companies within the holding company system that may materially affect the operations, management or financial condition of the insurers within the system. Pursuant to these laws, the respective insurance departments may examine Indemnity, as the management company, the Property and Casualty Group and EFL at any time, and may require disclosure and/or prior approval of certain transactions with the insurers and Indemnity, as an insurance holding company.

All transactions within the holding company system affecting the insurers Indemnity manages are filed with the applicable insurance departments and must be fair and reasonable. Approval of the applicable insurance commissioner is required prior to the consummation of transactions affecting the control of an insurer. In some states, the acquisition of 10% or more of the outstanding common stock of an insurer or its holding company is presumed to be a change in control. The sale of Indemnity's wholly owned property and casualty insurance subsidiaries, EIC, ENY and EPC, and the sale of Indemnity's 21.6% ownership interest in EFL have both been approved by the appropriate regulatory agencies. Approval of the applicable insurance commissioner is also required in order to declare extraordinary dividends. See Item 8, Financial Statements and Supplementary Data Note 22, Statutory Information, of Notes to Consolidated Financial Statements contained within this report.

**Website Access**

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports are available free of charge on our website at [www.erieinsurance.com](http://www.erieinsurance.com) as soon as reasonably practicable after such material is filed electronically with the Securities Exchange Commission. Additionally, copies of our annual report on Form 10-K are available free of charge, upon written request, by contacting Investor Relations, Erie Indemnity Company, 100 Erie Insurance Place, Erie, PA 16530, or calling 1-800-458-0811.

Our Code of Conduct is also available on our website and in printed form upon request, and our information statement on Form 14(C) is available free of charge on our website at [www.erieinsurance.com](http://www.erieinsurance.com).

Table of Contents

**ITEM 1A. RISK FACTORS**

Our business involves various risks and uncertainties, including, but not limited to those discussed in this section. The events described in the risk factors below, or any additional risk outside of those discussed below, could have a material adverse effect on our business, financial condition, operating results or liquidity if they were to actually occur. This information should be considered carefully together with the other information contained in this report, including Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 8. Financial Statements and Supplementary Data, which includes the Notes to Consolidated Financial Statements, contained within this report.

**Risk Factors Related to the Indemnity Shareholder Interest**

*If the management fee rate paid by the Exchange is reduced or if there is a significant decrease in the amount of premiums written or assumed by the Exchange, revenues and profitability could be materially adversely affected.*

Indemnity is dependent upon management fees paid by the Exchange, which represent its principal source of revenue. Pursuant to the subscriber's agreements with the policyholders at the Exchange, Indemnity may retain up to 25% of all premiums written or assumed by the Exchange. Therefore, management fee revenue from the Exchange 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 arrangement. Accordingly, any reduction in direct premiums written by the Property and Casualty Group would have a proportional negative effect on Indemnity's revenues and net income. See Risk Factors Relating to the Non-Controlling Interest Owned by the Exchange, which includes the Property and Casualty Group and EFL, within this section for a discussion of risks impacting direct written premium.

The management fee rate is determined by our Board of Directors and may not exceed 25% of the premiums written or assumed by the Exchange. The Board of Directors sets the management fee rate each December for the following year. At their discretion, the rate can be changed at any time. The factors considered by the Board of Directors in setting the management fee rate include Indemnity's financial position in relation to the Exchange and the long-term needs of the Exchange for capital and surplus to support its continued growth and competitiveness. If the Exchange's surplus were significantly reduced, the management fee rate could be reduced and Indemnity's revenues and profitability could be materially adversely affected.

*If the costs of providing services to the Exchange are not controlled, Indemnity's revenues and profitability could be materially adversely affected.*

Pursuant to the subscriber's agreements with the policyholders at the Exchange, Indemnity is appointed to perform certain services, regardless of the cost of providing those services. These services relate to the sales, underwriting and issuance of policies on behalf of the Exchange. Indemnity incurs significant costs related to commissions, employees, and technology in order to provide these services. Inflation could negatively impact many of these costs.



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Commissions to independent agents are the largest component of Indemnity's cost of operations. Commissions include scheduled commissions to agents based upon premiums written as well as additional commissions and bonuses to agents, which are earned by achieving certain targeted measures. Changes to commission rates or bonus programs may result in increased future costs and lower profitability.

Employees are an essential part of the operating costs related to providing services for the Exchange. As a result, Indemnity's profitability is affected by employee costs, including salaries and medical, pension and other benefit costs. Recent regulatory developments, provider relationships, and economic factors that are beyond our control indicate that employee healthcare costs will continue to increase. Although Indemnity actively manages these cost increases, there can be no assurance that future cost increases will not occur and reduce its profitability.

Technological development is necessary to reduce Indemnity's costs, to reduce the Property and Casualty Group's operating costs, and to facilitate agents' and policyholders' ability to do business with the Property and Casualty Group. If we are unable to keep pace with the advancements in technology, our ability to compete with other insurance companies who have advanced technological capabilities will be negatively affected. This could result in additional costs as we invest in new technology and systems.

Table of Contents

*Our ability to attract, develop and retain talented executives, key managers and employees is critical to our success.*

Our future performance is substantially dependent upon our ability to attract, motivate and retain executives and other key management. The loss of the services and leadership of certain key officers and the failure to attract, motivate and develop talented new executives and managers could prevent us from successfully communicating, implementing and executing business strategies, and therefore have a material adverse effect on our financial condition and results of operations.

Our success also depends on our ability to attract, develop and retain a talented employee base. The inability to staff all functions of our business with employees possessing the appropriate technical expertise could have an adverse effect on our business performance. Staffing appropriately skilled employees for the deployment and maintenance of information technology systems, the appropriate handling of claims, and rendering of disciplined underwriting is critical to the success of our business.

*If we are unable to keep pace with technological advancements in the insurance industry or are unable to ensure system availability or to secure system information, the ability of the Erie Insurance Group to compete effectively could be impaired.*

Indemnity is responsible for providing the technological resources necessary to support the operations of the Erie Insurance Group. Our business is highly dependent upon the effective operations of our technology and information systems. We rely upon these systems to assist in key functions of core business operations including processing claims, applications, and premium payments, providing customer support, performing actuarial and financial analysis, and maintaining key data. We have an established business continuity plan to ensure the continuation of core business operations in the event that normal business operations could not be performed due to a catastrophic event. While we continue to test and assess our business continuity plan to ensure it meets the needs of our core business operations and addresses multiple business interruption events, there is no assurance that core business operations could be performed upon the occurrence of such an event. Our information technology systems interface with and rely upon third-party systems. The failure of our information systems for any reason could result in a material adverse effect on our business, financial condition, or results of operations.

Advancements in technology continue to make it easier to store, share and transport information. While we have tools in place to monitor the flow of information and address identity, threat, vulnerability and trust management, a security breach of our computer systems could interrupt or damage our operations or harm our reputation if confidential company or customer information were to be misappropriated from our systems. Cases where sensitive data is exposed or lost may lead to a loss in competitive advantage or lawsuits.

*The performance of Indemnity's investment portfolio is subject to a variety of investment risks, which may in turn have a material adverse effect on its results of operations or financial condition.*

Indemnity's investment portfolio is comprised principally of fixed-income maturities and limited partnerships. At December 31, 2011, Indemnity's investment portfolio consisted of approximately 68% fixed income securities, 26% limited partnerships, and 6% equity securities.

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All of Indemnity's marketable securities are subject to market volatility. To the extent that future market volatility negatively impacts Indemnity's investments, its financial condition will be negatively impacted. We review the investment portfolio on a continuous basis to evaluate positions that might have incurred other-than-temporary declines in value. The primary factors considered in our review of investment valuation include the extent and duration to which fair value is less than cost, historical operating performance and financial condition of the issuer, short- and long-term prospects of the issuer and its industry, specific events that occurred affecting the issuer, including rating downgrades and, depending on the type of security, our intent to sell or our ability and intent to retain the investment for a period of time sufficient to allow for a recovery in value. As the process for determining impairments is highly subjective, changes in our assessments may have a material effect on Indemnity's operating results and financial condition. See also Item 7A. Quantitative and Qualitative Disclosures about Market Risk .

If the fixed-income, equity, or limited partnership portfolios were to suffer a substantial decrease in value, Indemnity's financial position could be materially adversely affected through increased unrealized losses or impairments.

Currently, 40% of the fixed-income portfolio is invested in municipal securities. The performance of the fixed-income portfolio is subject to a number of risks including:

Table of Contents

- Interest rate risk the risk of adverse changes in the value of fixed-income securities as a result of increases in market interest rates.
- Investment credit risk the risk that the value of certain investments may decrease due to the deterioration in financial condition of, or the liquidity available to, one or more issuers of those securities or, in the case of asset-backed securities, due to the deterioration of the loans or other assets that underlie the securities, which, in each case, also includes the risk of permanent loss.
- Concentration risk the risk that the portfolio may be too heavily concentrated in the securities of one or more issuers, sectors, or industries, which could result in a significant decrease in the value of the portfolio in the event of a deterioration of the financial condition, performance, or outlook of those issuers, sectors, or industries.
- Liquidity risk the risk that Indemnity will not be able to convert investment securities into cash on favorable terms and on a timely basis, or that Indemnity will not be able to sell them at all, when desired. Disruptions in the financial markets, or a lack of buyers for the specific securities that Indemnity is trying to sell, could prevent it from liquidating securities or cause a reduction in prices to levels that are not acceptable to Indemnity.

In addition to the fixed-income securities, a significant portion of Indemnity's portfolio is invested in limited partnerships. At December 31, 2011, Indemnity had investments in limited partnerships of \$208 million, or 17% of total assets. In addition, Indemnity is obligated to invest up to an additional \$40 million in limited partnerships, including private equity, mezzanine debt, and real estate partnership investments. Limited partnerships are significantly less liquid and generally involve higher degrees of price risk, the risk of potential loss in estimated fair value resulting from an adverse change in prices, than publicly traded securities. Limited partnerships, like publicly traded securities, have exposure to market volatility; but unlike fixed-income securities, cash flows and return expectations are less predictable. The primary basis for the valuation of limited partnership interests are financial statements prepared by the general partner. Because of the timing of the preparation and delivery of these financial statements, the use of the most recently available financial statements provided by the general partners result in a quarter delay in the inclusion of the limited partnership results in our Consolidated Statements of Operations. Due to this delay, Indemnity's financial statements at December 31, 2011, do not reflect market conditions experienced in the fourth quarter of 2011.

Indemnity's equity securities have exposure to price risk. Indemnity does not hedge its exposure to equity price risk inherent in its equity investments. Equity markets, sectors, industries, and individual securities may also be subject to some of the same risks that affect Indemnity's fixed-income portfolio, as discussed above.

*Indemnity is subject to credit risk from the Exchange because the management fees from the Exchange are not paid immediately when premiums are written.*

Indemnity recognizes management fees due from the Exchange as income when the premiums are written because at that time Indemnity has performed substantially all of the services it is required to perform, including sales, underwriting and policy issuance activities. However, such fees are not paid to Indemnity by the Exchange until the Exchange collects the premiums from policyholders. As a result, Indemnity holds receivables for management fees since such fees are based upon premiums that have been written and assumed. Indemnity also holds receivables from the Exchange for costs it pays on the Exchange's behalf. The receivable from the Exchange totaled \$254 million or 21% of our

total assets at December 31, 2011.

*Deteriorating capital and credit market conditions may significantly affect Indemnity's ability to meet liquidity needs and access capital.*

Sufficient liquidity and capital levels are required to pay operating expenses, income taxes, and to provide the necessary resources to fund future growth opportunities, pay dividends, and repurchase stock. Management estimates the appropriate level of capital necessary based upon current and projected results, which include a factor for potential exposures based upon these Risk Factors. Failure to accurately estimate Indemnity's capital needs may have a material adverse effect on its financial condition until additional sources of capital can be located. Further, a deteriorating financial condition may create a negative perception of Indemnity by third parties, including rating agencies, investors, agents, and customers which could impact Indemnity's ability to access additional capital in the debt or equity markets.

Table of Contents

The primary sources of liquidity for Indemnity are management fees and cash flows generated from its investment portfolio. In the event Indemnity's current sources do not satisfy its liquidity needs, Indemnity has the ability to access its \$100 million bank revolving line of credit, from which there were no borrowings as of December 31, 2011, or sell assets in its investment portfolio. Volatility in the financial markets could impair Indemnity's ability to sell certain of its fixed income securities or, to a greater extent, its significantly less liquid limited partnership investments, or cause such investments to sell at deep discounts.

In the event these traditional sources of liquidity are not available, Indemnity may have to seek additional financing. Indemnity's access to funds will depend upon a number of factors including current market conditions, the availability of credit to the financial services industry, market liquidity, and credit ratings. In deteriorating market conditions, Indemnity may not be able to obtain additional financing on favorable terms, or at all.

*Indemnity is subject to applicable insurance laws and regulations, as well as claims and legal proceedings, which, if determined unfavorably, could have a material adverse effect on Indemnity's business, results of operations or financial condition.*

Indemnity faces a significant risk of litigation and regulatory investigations and actions in the ordinary course of operating its businesses including the risk of class action lawsuits. Indemnity's pending legal and regulatory actions include proceedings specific to Indemnity and others generally applicable to business practices in the industries in which it operates. In Indemnity's management operations, we are, have been, or may become subject to class actions and individual suits alleging, among other things, issues relating to sales or underwriting practices, payment of contingent or other sales commissions, product design, product disclosure, policy issuance and administration, additional premium charges for premiums paid on a periodic basis, charging excessive or impermissible fees on products, recommending unsuitable products to customers, and breaching alleged fiduciary or other duties to customers. Indemnity is also subject to litigation arising out of its general business activities such as its contractual and employment relationships. Plaintiffs in class action and other lawsuits against Indemnity may seek very large or indeterminate amounts, including punitive and treble damages, which may remain unknown for substantial periods of time. Indemnity is also subject to various regulatory inquiries, such as information requests, subpoenas and books and record examinations from state and federal regulators and authorities. Changes in the way regulators administer those laws or regulations could adversely impact Indemnity's business, results of operations or financial condition. See Risk Factors Related to the Non-Controlling Interest Owned by the Exchange, which Includes the Property and Casualty Group and EFL, that follows for additional discussion of litigation risks.

**Risk Factors Relating to the Non-Controlling Interest Owned by the Exchange, which Includes the Property and Casualty Group and EFL**

*Deteriorating general economic conditions may have an adverse effect on the non-controlling interest's operating results and financial condition.*

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.

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In addition, downward economic trends also may have an adverse effect on both Indemnity's and the Property and Casualty Group's investment results by negatively impacting the business conditions and impairing credit for the issuers of securities held in their respective investment portfolios. This could reduce fair values of investments and generate significant unrealized losses or impairment charges which may adversely affect their respective financial results.

*The Property and Casualty Group depends on independent insurance agents, which exposes the Property and Casualty Group to risks not applicable to companies with exclusive agents or other forms of distribution.*

The Property and Casualty Group markets and sells its insurance products through independent, non-exclusive agencies. These agencies are not obligated to sell only the Property and Casualty Group's insurance products, and generally they also sell competitors' insurance products. As a result, the Property and Casualty Group's business depends in large part on the marketing and sales efforts of these agencies. To the extent these agencies' marketing

Table of Contents

efforts cannot be maintained at their current levels of volume or they bind the Property and Casualty Group to unacceptable insurance risks, fail to comply with established underwriting guidelines or otherwise improperly market the Property and Casualty Group's products, the results of operations and business of the Property and Casualty Group could be adversely affected. Also, to the extent these agencies place business with competing insurers due to compensation arrangements, product differences, price differences, ease of doing business or other reasons, the results of operations of the Property and Casualty Group could be adversely affected. If the Property and Casualty Group is unsuccessful in maintaining and/or increasing the number of agencies in its independent agent distribution system, the results of operations of the Property and Casualty Group could be adversely affected. To the extent that consumer preferences cause the insurance industry to migrate to a delivery system other than independent agencies, the business of the Property and Casualty Group could be adversely affected. Also, to the extent the agencies choose to place significant portions or all of their business with competing insurance companies, the results of operations and business of the Property and Casualty Group could be adversely affected.

*Our ability to maintain our reputation is a key factor to the Property and Casualty Group's success.*

The Property and Casualty Group maintains a brand recognized for customer service. Incidents such as a failure to protect sensitive customer data, errors in processing a claim, long customer wait times, systems failures, agency disputes, unfavorable litigation or inappropriate social media communications, among others, may result in reputational harm to the Property and Casualty Group's brand and the potential for a reduction in business. Further, if an extreme catastrophic event were to occur in a heavily concentrated area of policyholders, and extraordinarily high number of claims could have the potential to strain claims processing and affect our ability to satisfy our customers. The degree of control we have over these events varies significantly based upon the type of event. While we maintain and execute processes to minimize these events, we cannot completely eliminate this risk.

*The Property and Casualty Group faces significant competition from other regional and national insurance companies. Failure to keep pace with competitors may result in lower market share and revenues, which may have a material adverse affect on the Property and Casualty Group's financial condition.*

The Property and Casualty Group competes with regional and national property and casualty insurers including direct writers of insurance coverage. Many of these competitors are larger and many have greater financial, technical and operating resources. In addition, there is competition within each independent insurance agency that represents other carriers as well as the Property and Casualty Group.

If we are unable to perform at industry best practice levels in terms of quality, cost containment, and speed-to-market due to inferior operating resources and/or problems with external relationships, the Property and Casualty Group's business performance may suffer. As the business environment changes, if we are unable to adapt timely to emerging industry changes, or if our people do not conform to the changes, the Property and Casualty Group's business could be materially impacted.

The property and casualty insurance industry is highly competitive on the basis of product, price and service. If competitors offer property and casualty products with more coverage and/or better service or offer lower rates, and we are unable to implement product or service improvements quickly enough to keep pace, the Property and Casualty Group's ability to grow and renew its business may be adversely impacted.



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The internet continues to grow as a method of product distribution, and as a preferred method of product and price comparison. We compete against established direct to consumer insurers as well as insurers that use a combination of agent and online distribution. We expect the competitors in this channel to grow. Failure to position our distribution technology effectively in light of these trends and changing demographics could inhibit the Property and Casualty Group's ability to grow and maintain its customer base. The Property and Casualty Group's growth could also be adversely impacted by an inability to accommodate prospective customers based upon lack of geographic agency presence.

*Changes in applicable insurance laws, regulations or changes in the way regulators administer those laws or regulations could adversely change the Property and Casualty Group's operating environment and increase its exposure to loss or put it at a competitive disadvantage.*

Property and casualty insurers are subject to extensive supervision in the states in which they do business. This regulatory oversight includes, by way of example, matters relating to licensing examination, rate setting, market conduct, policy forms, limitations on the nature and amount of certain investments, claims practices, mandated

Table of Contents

participation in involuntary markets and guaranty funds, reserve adequacy, insurer solvency, restrictions on underwriting standards, and transactions between affiliates. Such regulation and supervision are primarily for the benefit and protection of policyholders and not for the benefit of shareholders. For instance, members of the Property and Casualty Group are subject to involuntary participation in specified markets in various states in which they operate, and the rate levels the Property and Casualty Group is permitted to charge do not always correspond with the underlying costs associated with the coverage issued. Additionally, material transactions and agreements between Indemnity and the Exchange must be approved by the appropriate state insurance department(s). Although currently the federal government does not directly regulate the insurance industry, federal programs, such as federal terrorism backstop legislation and the Federal Insurance Office established under the Dodd-Frank Act can also impact the insurance industry. In addition to specific insurance regulation, the Property and Casualty Group must also comply with other regulatory, legal and ethical requirements relating to the general operation of a business.

*Premium rates and reserves must be established for members of the Property and Casualty Group from forecasts of the ultimate costs expected to arise from risks underwritten during the policy period. The Property and Casualty Group's underwriting profitability could be adversely affected to the extent such premium rates or reserves are too low or by the effects of inflation.*

One of the distinguishing features of the property and casualty insurance industry in general is that its products are priced before its costs are known, as premium rates are generally determined before losses are reported. 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 impact personal and commercial auto, general liability, workers compensation and commercial multi-peril lines of insurance written by the Property and Casualty Group. Accordingly, premium rates must be established from forecasts of the ultimate costs expected to arise from risks underwritten during the policy period. These premium rates may prove to be inadequate if future inflation is significantly higher than the inflation anticipated in pricing.

Further, property and casualty insurers establish reserves for losses and loss expenses that will not be paid and settled for many years. Numerous factors affect both the current estimates and final settlement value of these losses and loss expenses. It is possible that the ultimate liability for these losses and loss expenses will exceed these reserves because of unanticipated changes in the future development of known losses, the unanticipated emergence of losses that have occurred but are currently unreported, and larger than expected settlements on pending and unreported claims. The process of estimating reserves is inherently judgmental and can be influenced by factors that are subject to variation. If pricing or reserves of the Property and Casualty Group are not sufficient, the Property and Casualty Group's underwriting profitability may be adversely impacted.

The property and casualty insurance industry has historically been cyclical with periods of intense price competition. The Property and Casualty Group seeks an appropriate balance between profitability and premium growth. Periods of intense price competition in the cycle could adversely affect the Property and Casualty Group's financial condition, profitability, or cash flows.

*Emerging claims and coverage issues in the insurance industry are unpredictable and could cause an adverse effect on the Property and Casualty Group's results of operations or financial condition.*

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect the Property and Casualty Group's business by either extending coverage beyond its underwriting intent or by increasing the number or size of claims. In some instances, these emerging issues may not become apparent for some time after the Property and Casualty Group has issued the affected insurance policies. As a result, the full extent of liability under the Property and Casualty Group's insurance policies may not be known for many years after the policies are issued.

*Changes in reserve estimates may adversely affect EFL's operating results.*

Reserves for life-contingent contract benefits are computed on the basis of long-term actuarial assumptions of future investment yields, mortality, morbidity, persistency and expenses. We periodically review the adequacy of these reserves on an aggregate basis and, if future experience differs significantly from assumptions, adjustments to reserves and amortization of deferred policy acquisition costs may be required, which could have a material adverse effect on EFL's operating results.

Table of Contents

*The financial performance of members of the Property and Casualty Group could be adversely affected by severe weather conditions or other catastrophic losses, including terrorism.*

The Property and Casualty Group conducts business in 11 states and the District of Columbia, primarily in the Mid-Atlantic, Midwestern and Southeastern portions of the United States. A substantial portion of this business is private passenger and commercial automobile, homeowners and workers compensation insurance in Ohio, North Carolina, Maryland, Virginia and particularly, Pennsylvania. As a result, a single catastrophic occurrence, destructive weather pattern, change in climate condition, general economic trend, terrorist attack, regulatory development or other condition disproportionately affecting one or more of the states in which the Property and Casualty Group conducts substantial business could adversely affect the results of operations of members of the Property and Casualty Group. Common natural catastrophic events include hurricanes, earthquakes, tornadoes, hail storms and severe winter weather. The frequency and severity of these catastrophes is inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposures in the area affected by the event and the severity of the event.

Terrorist attacks could also cause losses from insurance claims related to the property and casualty insurance operations, as well as a decrease in our equity, net income or revenue. The federal Terrorism Risk Insurance Program Reauthorization and Extension Act of 2007 requires that some coverage for terrorist losses be offered by primary commercial property insurers and provides federal assistance for recovery of claims through 2014. While the Property and Casualty Group is exposed to terrorism losses in commercial lines and workers compensation, these lines are afforded a limited backstop above insurer deductibles for acts of terrorism under this federal program. The Property and Casualty Group has no personal lines terrorist coverage in place. The Property and Casualty Group could incur large net losses if terrorist attacks were to occur.

The Property and Casualty Group maintains several property catastrophe reinsurance treaties that were renewed effective January 1, 2012, with a first treaty providing coverage of up to 90% of a loss of \$500 million in excess of the Property and Casualty Group's loss retention of \$350 million per occurrence, and a second treaty providing coverage of up to 70% of a loss of \$275 million in excess of \$850 million. In addition, a third treaty was entered into with a nonaffiliated reinsurer providing coverage of up to 70% of a loss of \$25 million in excess of \$1.125 billion. These treaties exclude losses from acts of terrorism. Catastrophe reinsurance may prove inadequate if a major catastrophic loss exceeds the reinsurance limit which could adversely affect the Property and Casualty Group's underwriting profitability and financial position.

*The inability to acquire reinsurance coverage at reasonable rates or collect amounts due from reinsurers could have an adverse effect on the Property and Casualty Group.*

The availability and cost of reinsurance are subject to prevailing market conditions, both in terms of price and available capacity. The availability of reinsurance capacity can be impacted by general economic conditions and conditions in the reinsurance market, such as the occurrence of significant reinsured events. The availability and cost of reinsurance could affect the Property and Casualty Group's business volume and profitability.

Although the reinsurer is liable to the Property and Casualty Group to the extent of the ceded reinsurance, the Property and Casualty Group remains liable as the direct insurer on all risks reinsured. Reinsurance contracts do not relieve the Property and Casualty Group from its primary obligations to policyholders. As a result, ceded reinsurance arrangements do not eliminate the Property and Casualty Group's obligation to pay claims. Accordingly, the Property and Casualty Group is subject to credit risk with respect to its ability to recover amounts due from reinsurers. The Property and Casualty Group's inability to collect a material recovery from a reinsurer could have an adverse effect on its underwriting profitability and financial condition.

*The performance of the Exchange's investment portfolio is subject to a variety of investment risks, which may in turn have a material adverse effect on its results of operations or financial condition.*

The Exchange's investment portfolio is comprised principally of fixed-income maturities, common stocks, and limited partnerships. At December 31, 2011, the Exchange's investment portfolio consisted of approximately 65% fixed income securities, 20% common stocks, 10% limited partnerships, and 5% preferred equity securities.

All of the Exchange's marketable securities are subject to market volatility. To the extent that future market volatility negatively impacts the Exchange's investments, its financial condition will be negatively impacted. We review the

Table of Contents

investment portfolio on a continuous basis to evaluate positions that might have incurred other-than-temporary declines in value. The primary factors considered in our review of investment valuation include the extent and duration to which fair value is less than cost, historical operating performance and financial condition of the issuer, short- and long-term prospects of the issuer and its industry, specific events that occurred affecting the issuer including rating downgrades and, depending on the type of security, our intent to sell or our ability and intent to retain the investment for a period of time sufficient to allow for a recovery in value. As the process for determining impairments is highly subjective, changes in our assessments may have a material effect on the Exchange's operating results and financial condition. See also Item 7A.

Quantitative and Qualitative Disclosures about Market Risk

If the fixed-income, equity, or limited partnership portfolios were to suffer a substantial decrease in value, the Exchange's financial position could be materially adversely affected through increased unrealized losses or impairments. A significant decrease in the Exchange's portfolio could also put it, or its subsidiaries, at risk of failing to satisfy regulatory minimum capital requirements.

Currently, 32% of the Exchange's fixed-income portfolio is invested in financial sector securities and 19% is invested in municipal securities and results may vary depending on the market environment. The performance of the fixed-income portfolio is subject to a number of risks including:

- Interest rate risk the risk of adverse changes in the value of fixed-income securities as a result of increases in market interest rates.
- Investment credit risk the risk that the value of certain investments may decrease due to the deterioration in financial condition of, or the liquidity available to, one or more issuers of those securities or, in the case of asset-backed securities, due to the deterioration of the loans or other assets that underlie the securities, which, in each case, also includes the risk of permanent loss.
- Concentration risk the risk that the portfolio may be too heavily concentrated in the securities of one or more issuers, sectors, or industries, which could result in a significant decrease in the value of the portfolio in the event of a deterioration of the financial condition, performance, or outlook of those issuers, sectors, or industries.
- Liquidity risk the risk that the Exchange will not be able to convert investment securities into cash on favorable terms and on a timely basis, or that the Exchange will not be able to sell them at all, when desired. Disruptions in the financial markets, or a lack of buyers for the specific securities that the Exchange is trying to sell, could prevent it from liquidating securities or cause a reduction in prices to levels that are not acceptable to the Exchange.

The Exchange's common and preferred equity securities have exposure to price risk, the risk of potential loss in estimated fair value resulting from an adverse change in prices. The Exchange does not hedge its exposure to equity price risk inherent in its equity investments. The Exchange's common and preferred equity securities may also be subject to some of the same risks that affect the Exchange's fixed-income portfolio, as discussed above.

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In addition, a portion of the Exchange's portfolio is invested in limited partnerships. At December 31, 2011, the Exchange had investments in limited partnerships of \$1.1 billion, or 8% of total assets. In addition, the Exchange is obligated to invest up to an additional \$384 million in limited partnerships, including private equity, mezzanine debt, and real estate partnership investments. Limited partnerships are significantly less liquid and generally involve higher degrees of price risk than publicly traded securities. Limited partnerships, like publicly traded securities, have exposure to market volatility; but unlike fixed income securities, cash flows and return expectations are less predictable. The primary basis for the valuation of limited partnership interests are financial statements prepared by the general partner. Because of the timing of the preparation and delivery of these financial statements, the use of the most recently available financial statements provided by the general partners result in a quarter delay in the inclusion of the limited partnership results in our Consolidated Statements of Operations. Due to this delay, the Exchange's financial statements at December 31, 2011, do not reflect market conditions experienced in the fourth quarter of 2011.

*Deteriorating capital and credit market conditions may significantly affect the Exchange's ability to meet liquidity needs and access capital.*

Sufficient liquidity and capital levels are required to pay claims, claims-related expenses and income taxes as well as to build the Exchange's investment portfolio, provide for additional protection against possible large, unexpected losses and maintain adequate surplus amounts. Management estimates the appropriate level of capital necessary based

Table of Contents

upon current and projected results, which include a factor for potential exposures based upon these Risk Factors. Failure to accurately estimate the Exchange's capital needs may have a material adverse effect on the Exchange's financial condition until additional sources of capital can be located. Further, a deteriorating financial condition may create a negative perception of the Exchange by third parties, including rating agencies, investors, agents, and customers which could impact the Exchange's ability to access additional capital in the debt or equity markets.

The primary sources of liquidity for the Exchange are insurance premiums and cash flow generated from its investment portfolio. In the event the Exchange's current sources do not satisfy its liquidity needs, the Exchange has the ability to access its \$300 million bank revolving line of credit, from which there were no borrowings as of December 31, 2011, or sell assets in its investment portfolio. Volatility in the financial markets could impair the Exchange's ability to sell certain of its fixed income securities or, to a greater extent, its significantly less liquid limited partnership investments, or cause such investments to sell at deep discounts.

In the event these traditional sources of liquidity are not available, the Exchange may have to seek additional financing. The Exchange's access to funds will depend upon a number of factors including current market conditions, the availability of credit to the financial services industry, market liquidity, and credit ratings. In deteriorating market conditions, the Exchange may not be able to obtain additional financing on favorable terms, or at all.

*If there were a failure to maintain a commercially acceptable financial strength rating, the Property and Casualty Group's competitive position in the insurance industry would be adversely affected.*

Financial strength ratings are an important factor in establishing the competitive position of insurance companies and may be expected to have an effect on an insurance company's sales. Higher ratings generally indicate greater financial stability and a stronger ability to meet ongoing obligations to policyholders. Ratings are assigned by rating agencies to insurers based upon factors that the rating agencies believe are relevant to policyholders. Currently the Property and Casualty Group's pooled AM Best rating is an A+ (superior). A significant downgrade in this or other ratings would reduce the competitive position of the Property and Casualty Group making it more difficult to attract profitable business in the highly competitive property and casualty insurance market.

*The Property and Casualty Group is subject to claims and legal proceedings, which, if determined unfavorably to the Property and Casualty Group, could have a material adverse effect on our business, results of operations or financial condition.*

The Property and Casualty Group faces a significant risk of litigation and regulatory investigations and actions in the ordinary course of operating its businesses including the risk of class action lawsuits. The Property and Casualty Group's pending legal and regulatory actions include proceedings specific to the Property and Casualty Group and others generally applicable to business practices in the industries in which it operates. In the Property and Casualty Group's insurance operations, we are, have been, or may become subject to class actions and individual suits alleging, among other things, issues relating to claims payments and procedures, denial or delay of benefits, charging excessive or impermissible fees on products, and breaching fiduciary or other duties to customers. The Property and Casualty Group is also subject to litigation arising out of its general business activities such as its contractual relationships. Plaintiffs in class action and other lawsuits against the Property and Casualty Group may seek very large or indeterminate amounts, including punitive and treble damages, which may remain unknown for substantial periods of time. The Property and Casualty Group is also subject to various regulatory inquiries, such as information requests, subpoenas and books and record examinations from state and federal regulators and authorities. See Risk Factors Related to the Indemnity Shareholder Interest, within this section for additional discussion of litigation risks.



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*The Exchange is dependent upon Indemnity to perform certain services, including sales, underwriting, and the issuance of policies. Failure to perform these services effectively may have a material adverse effect on the financial condition of the Exchange.*

Pursuant to the attorney-in-fact agreements with the policyholders at the Exchange, Indemnity is responsible for performing key functions for the Exchange including management and operational services, including the related technology systems. The Exchange has no employees, as Indemnity employs all personnel related to performing operating functions for the Exchange. In addition, the Board of Directors for Indemnity has the responsibility for such Exchange-related activities as setting the management fee paid by the Exchange to Indemnity. As a result, the business and financial condition of the Exchange would be materially adversely affected if Indemnity was not able to provide the necessary operating and management services required by the Exchange.

Table of Contents

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

The companies comprising the Erie Insurance Group share a corporate home office complex in Erie, Pennsylvania, which comprises approximately 520,000 square feet and is owned by the Exchange.

The Erie Insurance Group also operates 24 field offices in 11 states. Of these offices, sixteen provide both agency support and claims services and are referred to as branch offices, while seven provide only claims services and are referred to as claims offices and one provides only agency support and is referred to as a sales office. Eight field offices are owned by the Erie Insurance Group (Indemnity owns three comprising approximately 40,000 square feet, the Exchange owns four comprising approximately 43,000 square feet, and EFL owns one comprising approximately 33,500 square feet), while the remaining 16 field offices are leased from unaffiliated parties, comprising approximately 123,000 square feet.

**ITEM 3. LEGAL PROCEEDINGS**

Reference is made to Item 8. Financial Statements and Supplementary Data - Note 20, Commitments and Contingencies, of Notes to Consolidated Financial Statements contained within this report.

**ITEM 4. REMOVED AND RESERVED**