

ERIE INDEMNITY CO  
Form 10-K  
February 23, 2017  
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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, 2016

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

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

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

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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	<input checked="" type="checkbox"/>	Accelerated Filer	<input type="checkbox"/>	Non-Accelerated Filer	<input type="checkbox"/>	Smaller Reporting Company	<input type="checkbox"/>
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(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: \$2.4 billion of Class A non-voting common stock as of June 30, 2016. 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:

46,189,068 shares of Class A common stock and 2,542 shares of Class B common stock outstanding on February 17, 2017.

DOCUMENTS INCORPORATED BY REFERENCE

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 Schedule 14(C) to be filed with the Securities and Exchange Commission no later than 120 days after December 31, 2016.

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PART I

ITEM 1. BUSINESS

General

Erie Indemnity Company ("Indemnity", "we", "us", "our") is a publicly held Pennsylvania business corporation that has since its incorporation in 1925 served as the attorney-in-fact for the subscribers (policyholders) at the Erie Insurance Exchange ("Exchange"). The Exchange, which also commenced business in 1925, is a Pennsylvania-domiciled reciprocal insurer that writes property and casualty insurance. We function solely as the management company and all insurance operations are performed by the Exchange. We operate our business as one segment.

Our primary function, as attorney-in-fact, 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 individually by each subscriber (policyholder), which appoints us as their common attorney-in-fact to transact certain 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, we earn a management fee calculated as a percentage, not to exceed 25%, of the direct and assumed premiums written by the Exchange. The management fee rate is set annually by our Board of Directors. The process of setting the management fee rate includes the evaluation of current year operating results compared to both prior year and industry estimated results for both Indemnity and the Exchange, and consideration of several factors for both entities including: their relative financial strength and capital position; projected revenue, expense and earnings for the subsequent year; future capital needs; as well as competitive position.

Services

The services we provide to the Exchange are related to the sales, underwriting and issuance of policies. The sales related services we provide include agent compensation and certain sales and advertising support services. Agent compensation includes scheduled commissions to agents based upon premiums written as well as additional commissions and bonuses to agents, which are earned by achieving targeted measures. Agent compensation comprised approximately 69% of our 2016 expenses. The underwriting services we provide include underwriting and policy processing and comprised approximately 10% of our 2016 expenses. The remaining services we provide include customer service and administrative support.

We also provide information technology services that support all the functions listed above that comprised approximately 9% of our 2016 expenses.

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have the ability to enter into contractual relationships and therefore Indemnity serves as the attorney-in-fact on behalf of the Exchange for all claims handling services, investment management services, and certain other common overhead and service department functions in accordance with the subscriber's agreement. The amounts Indemnity incurs on behalf of the Exchange in this capacity are reimbursed to Indemnity from the Exchange at cost. See Part II, Item 8. "Financial Statements and Supplementary Data - Note 13, Related Party, of Notes to Financial Statements" contained within this report.

Erie Insurance Exchange

Our primary purpose is to manage the affairs at the Exchange for the benefit of the policyholders. The Exchange is our sole customer and our earnings are largely generated from management fees based on the direct and assumed premiums written by the Exchange. We have no direct competition in providing these services to the Exchange.

The Exchange generates revenue by insuring preferred and standard risks, with personal lines comprising 71% of the 2016 direct and assumed written premiums and commercial lines comprising the remaining 29%. The principal personal lines products are private passenger automobile and homeowners. The principal commercial lines products

are commercial multi-peril, commercial automobile and workers compensation. Historically, due to policy renewal and sales patterns, the Exchange's direct and assumed written premiums are greater in the second and third quarters than in the first and fourth quarters of the calendar year.

The Exchange is represented by independent agencies that serve as its 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 an integral part of the Exchange's success.

Our results of operations are tied to the growth and financial condition of the Exchange. If any events occurred that impaired the Exchange's ability to grow or sustain its financial condition, including but not limited to reduced financial strength ratings, disruption in the independent agency relationships, significant catastrophe losses, or products not meeting customer demands, the Exchange could find it more difficult to retain its existing business and attract new business. A decline in the business of

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the Exchange almost certainly would have as a consequence a decline in the total premiums paid and a correspondingly adverse effect on the amount of the management fees we receive. We also have an exposure to a concentration of credit risk related to the unsecured receivables due from the Exchange for its management fee. See Part II, Item 8. "Financial Statements and Supplementary Data - Note 14, Concentrations of Credit Risk, of Notes to Financial Statements" contained within this report. See the risk factors related to our dependency on the growth and financial condition of the Exchange in Item 1A. "Risk Factors" contained within this report.

### Competition

Our primary function is to provide management services to the Exchange as set forth in the subscriber's agreement executed by each policyholder of the Exchange. There are a limited number of companies that provide services under a reciprocal insurance exchange structure. We do not directly compete against other such companies, given we are appointed by the policyholders of the Exchange to provide these services.

The direct and assumed premiums written by the Exchange drive our management fee which is our primary source of revenue. The property and casualty insurance industry is highly competitive. 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 Exchange are marketed exclusively through independent insurance agents, the Exchange 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. Industry capital levels can also significantly affect prices charged for coverage. Growth is driven by a company's ability to provide insurance services and competitive prices while maintaining target profit margins. 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 Exchange's strategic focus includes employing an underwriting philosophy and product mix targeted to produce an underwriting profit on a long-term basis through careful risk selection and rational pricing, and consistently providing superior service to policyholders and agents. The Exchange'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 support services. The Exchange also carefully selects the independent agencies that represent it and 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.

See the risk factors related to our dependency on the growth and financial condition of the Exchange in Item 1A. "Risk Factors" contained within this report for further discussion on competition in the insurance industry.

### Employees

We had almost 5,000 full-time employees at December 31, 2016, of which approximately 2,300, or 46%, provide claims related services exclusively for the Exchange. The Exchange reimburses us monthly for the cost of these services.

### Government Regulation

Most states have enacted legislation that regulates insurance holding company systems, defined as two or more affiliated persons, one or more of which is an insurer. The Exchange has the following wholly owned property and

casualty subsidiaries: Erie Insurance Company, Erie Insurance Company of New York, Erie Insurance Property and Casualty Company and Flagship City Insurance Company, and a wholly owned life insurance company, Erie Family Life Insurance Company ("EFL"). Indemnity and the Exchange, and its wholly owned subsidiaries, meet the definition of an insurance holding company system.

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 us, as the management company, and the Exchange and its wholly owned subsidiaries at any time, and may require disclosure and/or prior approval of certain transactions with the insurers and us, as an insurance holding company.

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All transactions within a holding company system affecting the member insurers of the holding company system must be fair and reasonable and any charges or fees for services performed must be reasonable. Approval by the applicable insurance commissioner is required prior to the consummation of transactions affecting the members within a holding company system.

### 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 and 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 (800) 458-0811.

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

## ITEM 1A. RISK FACTORS

Our business involves various risks and uncertainties, including, but not limited to those discussed in this section. The risks and uncertainties 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, cash flows, or liquidity if they were to develop into actual events. This information should be considered carefully together with the other information contained in this report and in other reports and materials we file periodically with the Securities and Exchange Commission.

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

We are dependent upon management fees paid by the Exchange, which represent our principal source of revenue. Pursuant to the subscriber's agreements with the policyholders at the Exchange, we may retain up to 25% of all direct and assumed premiums written by the Exchange. Therefore, management fee revenue from the Exchange is calculated by multiplying the management fee rate by the direct and assumed premiums written by the Exchange. Accordingly, any reduction in direct and assumed premiums written by the Exchange and/or the management fee rate would have a negative effect on our revenues and net income.

The management fee rate is determined by our Board of Directors and may not exceed 25% of the direct and assumed premiums written 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 process of setting the management fee rate includes the evaluation of current year operating results compared to both prior year and industry estimated results for both Indemnity and the Exchange, and consideration of several factors for both entities including: their relative financial strength and capital position; projected revenue, expense and earnings for the subsequent year; future capital needs; as well as competitive position. The evaluation of these factors could result in a reduction to the management fee rate and our revenues and profitability could be materially adversely affected.

If the costs of providing services to the Exchange are not controlled, our profitability could be materially adversely affected.



Pursuant to the subscriber's agreements with the policyholders at the Exchange, we are appointed to perform certain services. These services relate to the sales, underwriting, and issuance of policies on behalf of the Exchange. We incur significant costs related to commissions, employees, and technology in order to provide these services.

Commissions to independent agents are the largest component of our 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, our profitability is affected by employee costs, including salaries, healthcare, pension, and other benefit costs. Regulatory developments, provider relationships, and demographic and economic factors that are beyond our control indicate that employee healthcare costs will continue to increase. Although we actively manage these cost increases, there can be no assurance that future cost increases will not occur and reduce our profitability.

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Technological development is necessary to facilitate ease of doing business for the agents and policyholders of the Exchange and our employees. If we are unable to support our strategic initiatives or keep pace with advancements in technology, and do so cost effectively, our ability to compete may be negatively affected and result in lower revenues and reduced profitability for us. Furthermore, as we invest in new technology and systems, costs and completion times could exceed original estimates, and the results may not yield desired outcomes.

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

We recognize management fees due from the Exchange as income when the premiums are written because at that time we have performed substantially all of the services we are required to perform, including sales, underwriting, and policy issuance activities. However, such fees are not paid to us by the Exchange until the Exchange collects the premiums from policyholders. As a result, we hold receivables for management fees on premiums that have been written and assumed but not yet collected. We also hold receivables from the Exchange for costs we pay on the Exchange's behalf. The receivable from the Exchange totaled \$378.5 million, or approximately 25% of our total assets at December 31, 2016.

Serving as the attorney-in-fact in the reciprocal insurance exchange structure results in the Exchange being our sole customer. We have an interest in the growth of the Exchange as our earnings are largely generated from management fees based on the direct and assumed premiums written by the Exchange. If the Exchange's ability to grow or renew policies were adversely impacted, the premium revenue of the Exchange would be adversely affected which would reduce our management fee revenue. The circumstances or events that might impair the Exchange's ability to grow include, but are not limited to, the items discussed below.

Unfavorable changes in economic conditions, including declining consumer confidence, inflation, high unemployment, and the threat of recession, among others, may lead the Exchange's customers to modify coverage, not renew policies, or even cancel policies, which could adversely affect the premium revenue of the Exchange, and consequently our management fee.

The Exchange faces significant competition from other regional and national insurance companies. The property and casualty insurance industry is highly competitive on the basis of product, price and service. If the Exchange's competitors offer property and casualty products with more coverage or offer lower rates, and the Exchange is unable to implement product improvements quickly enough to keep pace, its ability to grow and renew its business may be adversely impacted. Likewise, an inability to match or exceed the service provided by competitors, which is increasingly relying on digital delivery and enhanced distribution technology, may impede the Exchange's ability to maintain and/or grow its customer base. In addition, due to the Exchange's focus on the automobile and homeowners insurance markets, it may be more sensitive to trends that could affect auto and home insurance coverages and rates over time, for example changing vehicle usage and driving patterns such as ride sharing, advancements in vehicle or home technology or safety features such as accident and loss prevention technologies, the development of autonomous vehicles, or residential occupancy patterns, among other factors.

The Exchange markets and sells its insurance products through independent, non-exclusive insurance agencies. These agencies are not obligated to sell only the Exchange's insurance products, and generally also sell products of the Exchange's competitors. If agencies do not maintain their current levels of marketing efforts, bind the Exchange to unacceptable risks, place business with competing insurers, or the Exchange is unsuccessful in attracting or retaining agencies in its distribution system as well as maintaining its relationships with those agencies, the Exchange's ability to grow and renew its business may be adversely impacted. Additionally, consumer preferences may cause the insurance industry as a whole to migrate to a delivery system other than independent agencies.

The Exchange maintains a brand recognized for customer service. The perceived performance, actions, conduct and behaviors of employees, independent insurance agency representatives, and third-party service partners may result in reputational harm to the Exchange's brand. Specific incidents which may cause harm include but are not limited to disputes, long customer wait times, errors in processing a claim, failure to protect sensitive customer data, and inappropriate social media communications. If third-party service providers fail to perform as anticipated, the Exchange may experience operational difficulties, increased costs and reputational damage. If an extreme catastrophic event were to occur in a heavily concentrated geographic area of policyholders, an extraordinarily high number of claims could have the potential to strain claims processing and affect the Exchange's ability to satisfy its customers. Any reputational harm to the Exchange could have the potential to impair its ability to grow and renew its business.

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Serving as the attorney-in-fact in the reciprocal insurance exchange structure results in the Exchange being our sole customer. We have an interest in the financial condition of the Exchange as our earnings are largely generated from management fees based on the direct and assumed premiums written by the Exchange. If the Exchange were to fail to maintain acceptable financial strength ratings, its competitive position in the insurance industry would be adversely affected. If a rating downgrade led to customers not renewing or canceling policies, or impacted the Exchange's ability to attract new customers, the premium revenue of the Exchange would be adversely affected which would reduce our management fee revenue. The circumstances or events that might impair the Exchange's financial condition include, but are not limited to, the items discussed below.

Financial strength ratings are an important factor in establishing the competitive position of insurance companies such as the Exchange. Higher ratings generally indicate greater financial stability and a stronger ability to meet ongoing obligations to policyholders. The Exchange's A.M. Best rating is currently A+ ("Superior"). Rating agencies periodically review insurers' ratings and change their rating criteria; therefore, the Exchange's current rating may not be maintained in the future. A significant downgrade in this or other ratings would reduce the competitive position of the Exchange, making it more difficult to attract profitable business in the highly competitive property and casualty insurance market and potentially result in reduced sales of its products and lower premium revenue.

The performance of the Exchange's investment portfolio is subject to a variety of investment risks. The Exchange's investment portfolio is comprised principally of fixed income securities, equity securities and limited partnerships. The fixed income portfolio is subject to a number of risks including, but not limited to, interest rate risk, investment credit risk, sector/concentration risk and liquidity risk. The Exchange's common stock 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. 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. If any investments in the Exchange's investment portfolio 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 or rating agency minimum capital requirements.

Property and casualty insurers are subject to extensive regulatory 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 participation in involuntary markets and guaranty funds, reserve adequacy, insurer solvency, restrictions on underwriting standards, accounting standards, and transactions between affiliates. Such regulation and supervision are primarily for the benefit and protection of policyholders. Changes in applicable insurance laws, regulations, or changes in the way regulators administer those laws or regulations could adversely change the Exchange's operating environment and increase its exposure to loss or put it at a competitive disadvantage, which could result in reduced sales of its products and lower premium revenue.

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

The Exchange's insurance operations are exposed to claims arising out of catastrophes. Common natural catastrophic events include hurricanes, earthquakes, tornadoes, hail storms, and severe winter weather. The frequency and severity

of these catastrophes is inherently unpredictable. Changing climate conditions have added to the unpredictability, frequency and severity of natural disasters and have created additional uncertainty as to future trends and exposures. A single catastrophic occurrence or aggregation of multiple smaller occurrences within its geographical region could adversely affect the financial condition of the Exchange. Terrorist attacks could also cause losses from insurance claims related to the property and casualty insurance operations. The Exchange could incur large net losses if terrorist attacks were to occur which could adversely affect its financial condition.

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

Our success is largely dependent upon our ability to attract and retain executives and other key management. The loss of the services and leadership of certain key officers and the failure to attract 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.

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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 handling of claims and servicing of customers, rendering of disciplined underwriting, and effective sales and marketing are critical to the core functions of our business. In addition, skilled employees in the actuarial, finance, and information technology areas are also essential to support our core functions.

If we are unable to ensure system availability, unable to secure sensitive information, or we make significant decisions based on inaccurate data, we may experience adverse financial consequences and/or may be unable to compete effectively. Our business depends on the uninterrupted operations of our facilities, systems, and business functions.

Our business is highly dependent upon the effective operations of our technology and information systems. We also conduct business functions and computer operations using the systems of third-party vendors, which may provide software, data storage, cloud-based computing and other computer services to us. We rely upon our systems, and those of third-party vendors, 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 necessarily collect, use, and hold data concerning individuals, businesses, strategic plans, and intellectual property. Threats to data security, including unauthorized access, cyber attacks, and other computer related penetrations, expose us to additional costs for protection or remediation to secure our data in accordance with customer expectations and statutory and regulatory requirements, including data privacy laws. Preventative actions we take, or our third-party vendors take, to reduce the risk of cyber incidents and protect our information may be insufficient to prevent physical and electronic break-ins or other security breaches to our computer system as over time, the sophistication of these threats continues to increase. Additionally, a breach of security that results in unauthorized access to our data could expose us to an operational disruption, data loss, litigation, fines and penalties, increased compliance costs, and reputational damages. While we maintain cyber liability insurance to mitigate the amount of financial loss, our insurance coverage may not be sufficient to protect against all loss.

We depend on a large amount of data to price policies appropriately, track exposures, perform financial analysis, and ultimately make business decisions. Should this data be inaccurate or insufficient, risk exposure may be underestimated and/or poor business decisions may be made. This may in turn lead to adverse operational or financial performance.

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. Systems failures or outages could compromise our ability to perform our business functions in a timely manner, which could harm our ability to conduct business and hurt our relationships with our business partners and customers. Our business continuity is also dependent on third-party systems on which our information technology systems interface and rely. Our systems and those of our third-party vendors may become vulnerable to damage or disruption due to circumstances beyond our or their control, such as from catastrophic events, power anomalies or outages, natural disasters, network failures, and viruses. 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.

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

Our investment portfolio is comprised principally of fixed income securities and limited partnerships. At December 31, 2016, our investment portfolio consisted of approximately 90% fixed income securities, 9% limited partnerships, and 1% equity securities.

All of our marketable securities are subject to market volatility. To the extent that future market volatility negatively impacts our investments, our 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. Inherent in management's evaluation of a security are assumptions and estimates about the operations of the issuer and its future earnings potential. 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

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the process for determining impairments is highly subjective, changes in our assessments may have a material effect on our 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, our financial position could be materially adversely affected through increased unrealized losses or impairments.

The performance of the fixed income portfolio is subject to a number of risks including, but not limited to:

**Interest rate risk** - the risk of adverse changes in the value of fixed income securities as a result of increases in market interest rates. A sustained low interest rate environment would pressure our net investment income.

**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.

**Sector/Concentration risk** - the risk that the portfolio may be too heavily concentrated in the securities of one or more issuers, sectors, or industries. Events or developments that have a negative impact on any particular industry, group of related industries, or geographic region may have a greater adverse effect on our investment portfolio to the extent that the portfolio is concentrated within those issuers, sectors, or industries.

**Liquidity risk** - the risk that we will not be able to convert investment securities into cash on favorable terms and on a timely basis, or that we 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 we are trying to sell, could prevent us from liquidating securities or cause a reduction in prices to levels that are not acceptable to us.

General economic conditions and other factors beyond our control can adversely affect the value of our investments and the realization of net investment income, or result in realized investment losses. In addition, downward economic trends also may have an adverse effect on our 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 our financial results.

In addition to the fixed income securities, a portion of our portfolio is invested in limited partnerships. At December 31, 2016, we had investments in limited partnerships of \$58.2 million, or 4% of total assets. In addition, we are obligated to invest up to an additional \$16.9 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. We have made no new limited partnership commitments since 2006, and the balance of limited partnership investments is expected to decline over time as additional distributions are received.

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 Statements of Operations. Due to this delay, our financial statements at December 31, 2016 do not reflect market conditions experienced in the fourth quarter of 2016.



Our equity securities have exposure to price risk. We do not hedge our exposure to equity price risk inherent in our equity investments. Equity markets, sectors, industries, and individual securities may also be subject to some of the same risks that affect our fixed income portfolio, as discussed above.

Deteriorating capital and credit market conditions or a failure to accurately estimate capital needs may significantly affect our 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 on common stock, and repurchase common stock. Management estimates the appropriate level of capital necessary based upon current and projected results, which include a loading for potential risks. Failure to accurately estimate our capital needs may have a material adverse effect on our financial condition until additional sources of capital can be located. Further, a deteriorating financial condition may create a negative perception

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of us by third parties, including rating agencies, investors, agents, and customers which could impact our ability to access additional capital in the debt or equity markets.

Our primary sources of liquidity are management fees and cash flows generated from our investment portfolio. In the event our current sources do not satisfy our liquidity needs, we have the ability to access our \$100 million bank revolving line of credit, from which there were no borrowings as of December 31, 2016, or sell assets in our investment portfolio. Volatility in the financial markets could limit our ability to sell certain of our fixed income securities or, to a greater extent, our 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, we may have to seek additional financing. Our access to funds will depend upon a number of factors including current market conditions, the availability of credit, market liquidity, and credit ratings. In deteriorating market conditions, there can be no assurance that we will obtain additional financing, or, if available, that the cost of financing will not substantially increase and affect our overall profitability.

We are subject to applicable insurance laws, tax statutes, and regulations, as well as claims and legal proceedings, which, if determined unfavorably, could have a material adverse effect on our business, results of operations, or financial condition.

We face a significant risk of litigation and regulatory investigations and actions in the ordinary course of operating our businesses including the risk of class action lawsuits. Our pending legal and regulatory actions include proceedings specific to us and others generally applicable to business practices in the industries in which we operate. In our 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, including our obligations to indemnify directors and officers in connection with certain legal matters. We are also subject to litigation arising out of our general business activities such as contractual and employment relationships and claims regarding the infringement of the intellectual property of others. Plaintiffs in class action and other lawsuits against us may seek very large or indeterminate amounts, including punitive and treble damages, which may remain unknown for substantial periods of time. We are 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, tax statutes, or regulations could adversely impact our business, results of operations, or financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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ITEM 2. PROPERTIES

Indemnity and the Exchange share a corporate home office complex in Erie, Pennsylvania, which comprises approximately 620,000 square feet. On November 11, 2016, we announced the construction of a new office building that will serve as part of our principal headquarters. The project is expected to span approximately three years and will add approximately 346,000 square feet to our existing home office complex. Additionally, we lease one office building and one warehouse facility from unaffiliated parties. We are charged rent for the related square footage we occupy.

Indemnity and the Exchange also operate 25 field offices in 12 states. Of these field offices, 17 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. We own three field offices and lease a portion of these buildings to the Exchange. The remaining field offices are leased from other parties as detailed below:

	Number of field offices
Field office ownership:	
Erie Indemnity Company	3
Erie Insurance Exchange	3
Erie Family Life Insurance Company	1
Unaffiliated parties <sup>(1)</sup>	18
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(1) Lease commitments for these properties expire periodically through 2022. We expect that most leases will be renewed or replaced upon expiration.

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ITEM 3. LEGAL PROCEEDINGS

State Court Lawsuit Against Erie Indemnity Company

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

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

Indemnity filed a motion in the state court in November 2012 seeking dismissal of the lawsuit. On December 19, 2013, the court granted Indemnity’s motion in part, holding that the Pennsylvania Insurance Holding Company Act “provides the [Pennsylvania Insurance] Department with special competence to address the subject matter of plaintiff’s claims” and referring “all issues” in the Sullivan lawsuit to the Pennsylvania Insurance Department (the “Department”) for “its views and any determination.” The court stayed all further proceedings and reserved decision on all other grounds for dismissal raised by Indemnity. Plaintiffs sought reconsideration of the court’s order, and on January 13, 2014, the court entered a revised order affirming its prior order and clarifying that the Department “shall decide any and all issues within its jurisdiction.” On January 30, 2014, Plaintiffs asked the court to certify its order to permit an immediate appeal to the Superior Court of Pennsylvania and to stay any proceedings in the Department pending completion of any appeal. On February 18, 2014, the court issued an order denying Plaintiffs’ motion. On March 20, 2014, Plaintiffs filed a petition for review with the Superior Court, which was denied by the Superior Court on May 5, 2014.

The Sullivan matter was assigned to an Administrative Judge within the Department for determination. The parties agreed that an evidentiary hearing was not required, entered into a stipulated record, and submitted briefing to the Department. Oral argument was held before the Administrative Judge on January 6, 2015. On April 29, 2015, the Department issued a declaratory opinion and order: (1) finding that the transactions between Exchange and Indemnity in which Indemnity retained or received revenue from installment and other service charges from Exchange subscribers complied with applicable insurance laws and regulations and that Indemnity properly retained charges paid by Exchange policyholders for certain installment premium payment plans, dishonored payments, policy cancellations, and policy reinstatements; and (2) returning jurisdiction over the matter to the Fayette County Court of Common Pleas.

On May 26, 2015, Plaintiffs appealed the Department’s decision to the Pennsylvania Commonwealth Court. Oral argument was held before the Commonwealth Court en banc on December 9, 2015. On January 27, 2016, the Commonwealth Court issued an opinion vacating the Department’s ruling and directing the Department to return the case to the Court of Common Pleas, essentially holding that the primary jurisdiction referral of the trial court was improper at this time because the allegations of the complaint do not implicate the special competency of the Department.

On February 26, 2016, Indemnity filed a petition for allowance of appeal to the Pennsylvania Supreme Court seeking further review of the Commonwealth Court opinion. On March 14, 2016, Plaintiffs filed an answer opposing Indemnity's petition for allowance of appeal; and, on March 28, 2016, Indemnity sought permission to file a reply brief in further support of its petition for allowance of appeal. On August 10, 2016, the Pennsylvania Supreme Court denied Indemnity's petition for allowance of appeal; and the Sullivan lawsuit returned to the Court of Common Pleas of Fayette County.

On September 12, 2016, Plaintiffs filed a motion to stay the Sullivan lawsuit pending the outcome of the Federal Court Lawsuit they filed against Indemnity and former and current Directors of Indemnity on July 8, 2016. (See below.) Indemnity filed an opposition to Plaintiff's motion to stay on September 19, 2016; and filed amended preliminary objections seeking dismissal of the Sullivan lawsuit on September 20, 2016. The motion to stay and the amended preliminary objections remain pending.

Indemnity believes that it continues to have meritorious legal and factual defenses to the Sullivan lawsuit and intends to vigorously defend against all allegations and requests for relief.

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Federal Court Lawsuit Against Directors

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

As subsequently amended, the Beltz lawsuit asserts many of the same allegations and claims for monetary relief as in the Sullivan lawsuit. Plaintiffs purport to sue on behalf of all policyholders of Exchange, or, alternatively, on behalf of Exchange itself. Indemnity filed a motion to intervene as a Party Defendant in the Beltz lawsuit in July 2013, and the Directors filed a motion to dismiss the lawsuit in August 2013. On February 10, 2014, the court entered an order granting Indemnity’s motion to intervene and permitting Indemnity to join the Directors’ motion to dismiss; granting in part the Directors’ motion to dismiss; referring the matter to the Department to decide any and all issues within its jurisdiction; denying all other relief sought in the Directors’ motion as moot; and dismissing the case without prejudice. To avoid duplicative proceedings and expedite the Department’s review, the Parties stipulated that only the Sullivan action would proceed before the Department and any final and non-appealable determinations made by the Department in the Sullivan action will be applied to the Beltz action.

On March 7, 2014, Plaintiffs filed a notice of appeal to the United States Court of Appeals for the Third Circuit. Indemnity filed a motion to dismiss the appeal on March 26, 2014. On November 17, 2014, the Third Circuit deferred ruling on Indemnity’s motion to dismiss the appeal and instructed the parties to address that motion, as well as the merits of Plaintiffs’ appeal, in the parties’ briefing. Briefing was completed on April 2, 2015. In light of the Department’s April 29, 2015 decision in Sullivan, the Parties then jointly requested that the Beltz appeal be voluntarily dismissed as moot on June 5, 2015. The Third Circuit did not rule on the Parties’ request for dismissal and instead held oral argument as scheduled on June 8, 2015. On July 16, 2015, the Third Circuit issued an opinion and judgment dismissing the appeal. The Third Circuit found that it lacked appellate jurisdiction over the appeal, because the District Court’s February 10, 2014 order referring the matter to the Department was not a final, appealable order.

On July 8, 2016, the Beltz plaintiffs filed a new action labeled as a “Verified Derivative And Class Action Complaint” in the United States District Court for the Western District of Pennsylvania. The action is captioned Patricia R. Beltz, Joseph S. Sullivan, and Anita Sullivan, individually and on behalf of all others similarly situated, and derivatively on behalf of Nominal Defendant Erie Insurance Exchange v. Erie Indemnity Company; Kaj Ahlmann; John T. Baily; Samuel P. Black, III; J. Ralph Borneman, Jr.; Terrence W. Cavanaugh; Wilson C. Cooney; LuAnn Datesh; Patricia A. Goldman; Jonathan Hirt Hagen; Thomas B. Hagen; C. Scott Hartz; Samuel P. Katz; Gwendolyn King; Claude C. Lilly, III; Martin J. Lippert; George R. Lucore; Jeffrey A. Ludrof; Edmund J. Mehl; Henry N. Nassau; Thomas W. Palmer; Martin P. Sheffield; Seth E. Schofield; Richard L. Stover; Jan R. Van Gorder; Elizabeth A. Hirt Vorsheck; Harry H. Weil; and Robert C. Wilburn (the “Beltz II” lawsuit). The individual defendants are all present or former Directors of Indemnity (the “Directors”).

The allegations of the Beltz II lawsuit arise from the same fundamental, underlying claims as the Sullivan and prior Beltz litigation, i.e., that Indemnity improperly retained Service Charges and Added Service Charges. The Beltz II lawsuit alleges that the retention of the Service Charges and Added Service Charges was improper because, for among other reasons, that retention constituted a breach of the Subscriber’s Agreement and an Implied Covenant of Good Faith and Fair Dealing by Indemnity, breaches of fiduciary duty by Indemnity and the other defendants, conversion by Indemnity, and unjust enrichment by defendants Jonathan Hirt Hagen, Thomas B. Hagen, Elizabeth A. Hirt Vorsheck, and Samuel P. Black, III, at the expense of Exchange. The Beltz II lawsuit requests, among other things, that a judgment be entered against the Defendants certifying the action as a class action pursuant to Rule 23 of the Federal

Rules of Civil Procedure; declaring Plaintiffs as representatives of the Class and Plaintiffs' counsel as counsel for the Class; declaring the conduct alleged as unlawful, including, but not limited to, Defendants' retention of the Service Charges and Added Service Charges; enjoining Defendants from continuing to retain the Service Charges and Added Service Charges; and awarding compensatory and punitive damages and interest.

On September 23, 2016, Indemnity filed a motion to dismiss the Beltz II lawsuit. On September 30, 2016, the Directors filed their own motions to dismiss the Beltz II lawsuit. The motions to dismiss remain pending.

Indemnity believes it has meritorious legal and factual defenses and intends to vigorously defend against all allegations and requests for relief in the Beltz II lawsuit. The Directors have advised Indemnity that they intend to vigorously defend against the claims in the Beltz II lawsuit and have sought indemnification and advancement of expenses from the Company in connection with the Beltz II lawsuit.

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For additional information on contingencies, see Part II, Item 8. "Financial Statements and Supplementary Data - Note 15, Commitment and Contingencies, of Notes to Financial Statements".

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

## Common Stock Market Prices and Dividends

Our Class A, non-voting common stock trades on The NASDAQ Stock Market<sup>SM</sup> LLC under the symbol "ERIE". No established trading market exists for the Class B voting common stock. American Stock Transfer & Trust Company, LLC serves as our transfer agent and registrar. As of February 17, 2017, there were approximately 663 beneficial shareholders of record for the Class A non-voting common stock and 9 beneficial shareholders of record for the Class B voting common stock.

Historically, we have declared and paid cash dividends on a quarterly basis at the discretion of the Board of Directors. The payment and amount of future dividends on the common stock will be determined by the Board of Directors and will depend upon, among other things, our operating results, financial condition, cash requirements, and general business conditions at the time such payment is considered. The common stock high and low sales prices and cash dividends declared for each full quarter of the last two years were as follows:

Quarter ended	2016				2015			
	Stock sales price		Cash dividend declared		Stock sales price		Cash dividend declared	
	High	Low	Class A	Class B	High	Low	Class A	Class B
March 31	\$100.53	\$89.92	\$0.7300	\$109.500	\$93.01	\$84.11	\$0.681	\$102.15
June 30	99.34	90.60	0.7300	109.500	87.15	80.02	0.681	102.15
September 30	103.69	96.68	0.7300	109.500	87.82	79.79	0.681	102.15
December 31	114.60	99.39	0.7825	117.375	100.56	81.37	0.730	109.50
Total			\$2.9725	\$445.875			\$2.773	\$415.95

## Stock Performance

The following graph depicts the cumulative total shareholder return, assuming reinvestment of dividends, for the periods indicated for our Class A common stock compared to the Standard & Poor's 500 Stock Index and the Standard & Poor's Supercomposite Insurance Industry Group Index. The Standard & Poor's Supercomposite Insurance Industry Group Index is made up of 55 constituent members represented by property and casualty insurers, insurance brokers, and life insurers, and is a capitalization weighted index.

	2011	2012	2013	2014	2015	2016
Erie Indemnity Company Class A common stock	\$100 <sup>(1)</sup>	\$95	\$102	\$131	\$143	\$171
Standard & Poor's 500 Stock Index	100 <sup>(1)</sup>	116	153	174	176	197
Standard & Poor's Supercomposite Insurance Industry Group Index	100 <sup>(1)</sup>	119	173	188	195	231

Assumes \$100 invested at the close of trading, including reinvestment of dividends, on the last trading day

(1) preceding the first day of the fifth preceding fiscal year, in our Class A common stock, the Standard & Poor's 500 Stock Index, and the Standard & Poor's Supercomposite Insurance Industry Group Index.

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## Issuer Purchases of Equity Securities

We may purchase shares, from time-to-time, in the open market, through trading plans entered into with one or more brokerage firms pursuant to Rule 10b5-1 under the Securities Exchange Act of 1934, or through privately negotiated transactions. The purchase of shares is dependent upon prevailing market conditions and alternate uses of capital, and at times and in a manner that is deemed appropriate.

Our Board of Directors authorized a stock repurchase program effective January 1, 1999, allowing the repurchase of our outstanding Class A nonvoting common stock. Various approvals for continuation of this program have since been authorized, with the most recent occurring in October 2011 for \$150 million, which was authorized with no time limitation. There were no repurchases of our Class A common stock under this program during the quarter ending December 31, 2016. We had approximately \$17.8 million of repurchase authority remaining under this program, based upon trade date, at both December 31, 2016 and February 17, 2017.

See Part II, Item 8. "Financial Statements and Supplementary Data – Note 11, Capital Stock, of Notes to Financial Statements" contained within this report for discussion of additional shares purchased outside of this program.

## ITEM 6. SELECTED FINANCIAL DATA

(in thousands, except per share data)

Years Ended December 31,

	2016	2015	2014	2013	2012
<b>Operating Data:</b>					
Operating revenue	\$1,596,631	\$1,505,508	\$1,407,119	\$1,297,331	\$1,188,430
Operating expenses	1,304,267	1,272,967	1,184,272	1,087,995	983,420
Investment income	27,828	33,708	28,417	37,278	36,204
Income before income taxes	320,091	266,249	251,264	246,614	241,214
Net income	210,366	174,678	167,505	162,611	160,145
<b>Per Share Data:</b>					
Net income per Class A share – diluted	\$4.01	\$3.33	\$3.18	\$3.08	\$2.99
Book value per share – Class A common and equivalent B shares	15.62	14.72	13.45	13.96	12.11
Dividends declared per Class A share	2.9725	2.773	2.586	2.4125	4.25
Dividends declared per Class B share	445.875	415.95	387.90	361.875	637.50
<b>Financial Position Data:</b>					
Investments	\$771,450	\$688,476	\$702,387	\$721,728	\$687,525
Receivables from Erie Insurance Exchange and affiliates	378,540	348,055	335,220	300,442	280,787
Long-term borrowings	24,766	—	—	—	—
Total assets	1,548,955	1,407,296	1,319,198	1,213,042	1,160,153
Total equity	816,910	769,503	703,134	733,982	641,870



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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of financial condition and results of operations highlights significant factors influencing Erie Indemnity Company ("Indemnity", "we", "us", "our"). This discussion should be read in conjunction with the audited financial statements and related notes and all other items contained within this Annual Report on Form 10-K as these contain important information helpful in evaluating our financial condition and results of operations.

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## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

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

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

- dependence upon our relationship with the Exchange and the management fee under the agreement with the subscribers at the Exchange;
- costs of providing services to the Exchange under the subscriber's agreement and investments in new technology and systems;
- credit risk from the Exchange;
- dependence upon our relationship with the Exchange and the growth of the Exchange, including:
  - general business and economic conditions;
  - factors affecting insurance industry competition;
  - dependence upon the independent agency system; and

ability to maintain our reputation for customer service;

dependence upon our relationship with the Exchange and the financial condition of the Exchange, including:  
the Exchange's ability to maintain acceptable financial strength ratings;  
factors affecting the quality and liquidity of the Exchange's investment portfolio;  
changes in government regulation of the insurance industry;  
emerging claims and coverage issues in the industry; and  
severe weather conditions or other catastrophic losses, including terrorism;  
ability to attract and retain talented management and employees;

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ability to maintain uninterrupted business operations and difficulties with technology or data security breaches, including cyber attacks;  
factors affecting the quality and liquidity of our investment portfolio;  
our ability to meet liquidity needs and access capital; and  
outcome of pending and potential litigation.

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

## RETROSPECTIVELY ADOPTED ACCOUNTING STANDARDS

In February 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2015-02, "Consolidation", which changed the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. This guidance changed the conditions to be met in determining if a reporting entity has a variable interest in a legal entity. In accordance with the new accounting guidance, Indemnity is not deemed to have a variable interest in the Exchange as the fees paid for services provided to the Exchange no longer represent a variable interest. The compensation received from the attorney-in-fact fee arrangement with the subscribers is for services provided by Indemnity acting in its role as attorney-in-fact and is commensurate with the level of effort required to perform those services. Under the previously issued accounting guidance, Indemnity was deemed to have a variable interest and was the primary beneficiary of the Exchange and its financial position and operating results were consolidated with Indemnity. Following adoption of the new accounting guidance, the Exchange's results are no longer required to be consolidated with Indemnity.

Indemnity adopted the new accounting standard on a retrospective basis effective with the annual reporting period ending December 31, 2015. The 2014 financial information within this report has been conformed to the presentation in accordance with the amended guidance.

## RECENT ACCOUNTING STANDARDS

See Part II, Item 8. "Financial Statements and Supplementary Data - Note 2, Significant Accounting Policies, of Notes to Financial Statements" contained within this report for a discussion of adopted as well as other recently issued accounting standards and the impact on our financial statements if known.

## OPERATING OVERVIEW

### Overview

We are a Pennsylvania business corporation that since 1925 has been the managing attorney-in-fact for the subscribers (policyholders) at the Erie Insurance Exchange ("Exchange"), a reciprocal insurer that writes property and casualty insurance. Our primary function is to perform certain services relating to the sales, underwriting and issuance of policies on behalf of the Exchange. We operate our business as one segment.

The Exchange is a reciprocal insurance exchange organized under Article X of Pennsylvania's Insurance Company Law of 1921 under which individuals, partnerships, and corporations are authorized to exchange reciprocal or inter-insurance contracts with each other, or with individuals, partnerships, and corporations of other states and countries, providing indemnity among themselves from any loss which may be insured against under any provision of

the insurance laws except life insurance. Each applicant for insurance to the Exchange signs a subscriber's agreement, which contains an appointment of Indemnity as their attorney-in-fact to transact the business of the Exchange on their behalf.

Pursuant to the subscriber's agreement and for its services as attorney-in-fact, we earn a management fee calculated as a percentage of the direct and assumed premiums written by the Exchange.

Our earnings are primarily driven by the management fee revenue generated for the services we provide relating to certain sales, underwriting, and issuance of policies for the Exchange. Management fee revenue is based upon all direct and assumed premiums written by the Exchange and the management fee rate, which is not to exceed 25%. Our Board of Directors establishes the management fee rate at least annually, generally in December for the following year. The process of setting the management fee rate includes the evaluation of current year operating results compared to both prior year and industry

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estimated results for both Indemnity and the Exchange, and consideration of several factors for both entities including: their relative financial strength and capital position; projected revenue, expense and earnings for the subsequent year; future capital needs; as well as competitive position.

The management fee rate was set at 25% for 2016, 2015 and 2014. Our Board of Directors set the 2017 management fee rate again at 25%, its maximum level.

The services we provide to the Exchange are related to the sales, underwriting and issuance of policies. The sales related services we provide include agent compensation and certain sales and advertising support services. Agent compensation includes scheduled commissions to agents based upon premiums written as well as additional commissions and bonuses to agents, which are earned by achieving targeted measures. Agent compensation comprised approximately 69% of our 2016 expenses. The underwriting services we provide include underwriting and policy processing and comprised approximately 10% of our 2016 expenses. The remaining services we provide include customer service and administrative support.

We also provide information technology services that support all the functions listed above that comprised approximately 9% of our 2016 expenses.

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have the ability to enter into contractual relationships and therefore Indemnity serves as the attorney-in-fact on behalf of the Exchange for all claims handling services, investment management services, and certain other common overhead and service department functions in accordance with the subscriber's agreement. The amounts Indemnity incurs on behalf of the Exchange in this capacity are reimbursed to Indemnity from the Exchange at cost. See Part II, Item 8. "Financial Statements and Supplementary Data - Note 13, Related Party, of Notes to Financial Statements" contained within this report.

Our results of operations are tied to the growth and financial condition of the Exchange as the Exchange is our sole customer and our earnings are largely generated from management fees based on the direct and assumed premiums written by the Exchange. The Exchange generates revenue by insuring preferred and standard risks, with personal lines comprising 71% of the 2016 direct and assumed written premiums and commercial lines comprising the remaining 29%. The principal personal lines products are private passenger automobile and homeowners. The principal commercial lines products are commercial multi-peril, commercial automobile and workers compensation.

We generate investment income from our fixed maturity, equity security, and limited partnership investment portfolios. Our portfolio is managed with the objective of maximizing after-tax returns on a risk-adjusted basis. We actively evaluate the portfolios for impairments, and record impairment write-downs on investments in instances where the fair value of the investment is substantially below cost, and it is concluded that the decline in fair value is other-than-temporary, which includes consideration for intent to sell.

## Financial Overview

(dollars in thousands, except per share data)	Years ended December 31,					
	2016	% Change	2015	% Change	2014	
Total operating revenue	\$ 1,596,631	6.1	% \$ 1,505,508	7.0	% \$ 1,407,119	
Total operating expenses	1,304,267	2.5	1,272,967	7.5	1,184,272	
Net revenue from operations	292,364	25.7	232,541	4.3	222,847	
Total investment income	27,828	(17.4)	33,708	18.6	28,417	
Interest expense, net	101	NM	—	NM	—	
Income before income taxes	320,091	20.2	266,249	6.0	251,264	
Income tax expense	109,725	19.8	91,571	9.3	83,759	
Net income	\$ 210,366	20.4	% \$ 174,678	4.3	% \$ 167,505	



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Net income per share - diluted	\$4.01	20.6 %	\$3.33	4.5 %	\$3.18
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NM = not meaningful

Net revenue from operations increased 25.7% in 2016 as revenue growth outpaced the growth in expenses, and 4.3% in 2015. The two components of our primary revenue source, management fee revenue, are the management fee rate we charge, and the direct and assumed premiums written by the Exchange. The management fee rate was 25% for both 2016 and 2015. The direct and assumed premiums written by the Exchange were \$6.3 billion in 2016 and \$5.9 billion in 2015.

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Total operating expenses increased 2.5% and 7.5% in 2016 and 2015, respectively. The increase in operating expenses for 2016 was driven by an increase in commissions, partially offset by lower non-commission expenses primarily from lower personnel costs across all expense categories. The increase in operating expenses for 2015 was driven primarily by increases in commissions and personnel costs.

Gross margin from operations increased to 18.3% in 2016 from 15.4% in 2015.

Total investment income decreased in 2016 primarily due to lower earnings generated from limited partnership investments.

**Reconciliation of Net Income to Operating Income**

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

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

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

The following table reconciles net income and operating income for the years ended December 31:  
(in thousands, except per share data)

	2016	2015	2014
Net income	\$210,366	\$174,678	\$167,505
Net realized (gains) losses and impairments on investments	(256 )	1,066	(952 )
Income tax expense (benefit)	89	(373 )	333
Realized (gains) losses and impairments, net of income taxes	(167 )	693	(619 )
Operating income	\$210,199	\$175,371	\$166,886
Per Class A common share-diluted:			
Net income	\$4.01	\$3.33	\$3.18
Net realized (gains) losses and impairments on investments	0.00	0.02	(0.02 )
Income tax expense (benefit)	0.00	(0.01 )	0.01
Realized (gains) losses and impairments, net of income taxes	0.00	0.01	(0.01 )
Operating income	\$4.01	\$3.34	\$3.17

**General Conditions and Trends Affecting Our Business****Economic conditions**

Unfavorable changes in economic conditions, including declining consumer confidence, inflation, high unemployment, and the threat of recession, among others, may lead the Exchange's customers to modify coverage, not renew policies, or even cancel policies, which could adversely affect the premium revenue of the Exchange, and

consequently our management fee. Further, unanticipated increased inflation costs including medical cost inflation, construction and auto repair cost inflation, and tort issues may impact the estimated loss reserves and future premium rates. If any of these items impacted the financial condition or continuing operations of the Exchange, it could have an impact on our financial results.

Financial market volatility

Our portfolio of fixed maturity, equity security, and limited partnership investments is subject to market volatility especially in periods of instability in the worldwide financial markets. Over time, net investment income could also be impacted by volatility and by the general level of interest rates, which impact reinvested cash flow from the portfolio and business operations. Depending upon market conditions, which are unpredictable and remain uncertain, considerable fluctuation could

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exist in the fair value of our investment portfolio and reported total investment income, which could have an adverse impact on our financial condition, results of operations, and cash flows.

### CRITICAL ACCOUNTING ESTIMATES

The financial statements include amounts based upon estimates and assumptions that have a significant effect on reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period and related disclosures. We consider an accounting estimate to be critical if 1) it requires assumptions to be made that were uncertain at the time the estimate was made, and 2) different estimates that could have been used, or changes in the estimate that are likely to occur from period-to-period, could have a material impact on our Statements of Operations or Financial Position.

The following presents a discussion of those accounting policies surrounding estimates that we believe are the most critical to our reported amounts and require the most subjective and complex judgment. If actual events differ significantly from the underlying assumptions, there could be material adjustments to prior estimates that could potentially adversely affect our results of operations, financial condition, and cash flows. The estimates and the estimating methods used are reviewed continually, and any adjustments considered necessary are reflected in current earnings.

#### Investment Valuation

##### Available-for-sale securities

We make estimates concerning the valuation of all investments. Valuation techniques are used to derive the fair value of the available-for-sale securities we hold. Fair value is the price that would be received to sell an asset in an orderly transaction between willing market participants at the measurement date.

Fair value measurements are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our view of market assumptions in the absence of observable market information. We utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

For purposes of determining whether the market is active or inactive, the classification of a financial instrument is based upon the following definitions:

- An active market is one in which transactions for the assets being valued occur with sufficient frequency and volume to provide reliable pricing information.

- An inactive (illiquid) market is one in which there are few and infrequent transactions, where the prices are not current, price quotations vary substantially, and/or there is little information publicly available for the asset being valued.

We continually assess whether or not an active market exists for all of our investments and as of each reporting date re-evaluate the classification in the fair value hierarchy. All assets carried at fair value are classified and disclosed in one of the following three categories:

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

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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.

Level 1 includes nonredeemable preferred stock and exchange traded funds, and reflects market data obtained from independent sources, such as prices obtained from an exchange or a nationally recognized pricing service for identical instruments in active markets.

Level 2 includes those financial instruments that are valued using industry-standard models that consider various inputs, such as the interest rate and credit spread for the underlying financial instruments. All significant inputs are observable, or derived

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from observable information in the marketplace, or are supported by observable levels at which transactions are executed in the marketplace. Financial instruments in this category primarily include U.S. government & agency securities, corporate bonds, municipal bonds, structured securities, redeemable preferred stock and certain nonredeemable preferred stock.

Level 3 securities are valued based upon unobservable inputs, reflecting our estimates of value based upon assumptions used by market participants. Securities are assigned to Level 3 in cases where non-binding broker quotes are significant to the valuation and there is a lack of transparency as to whether these quotes are based upon information that is observable in the marketplace. Fair value estimates for securities valued using unobservable inputs require significant judgment due to the illiquid nature of the market for these securities and represent the best estimate of the fair value that would occur in an orderly transaction between willing market participants at the measurement date under current market conditions. Fair value for these securities are generally determined using non-binding broker quotes received from outside broker dealers based upon security type and market conditions. Remaining securities, where a price is not available, are valued using an estimate of fair value based upon indicative market prices that include significant unobservable inputs not based upon, nor corroborated by, market information, including the utilization of discounted cash flow analyses which have been risk-adjusted to take into account illiquidity and other market factors. This category primarily consists of corporate debt securities priced using non-binding broker quotes.

As of each reporting period, financial instruments recorded at fair value are classified based upon the lowest level of input that is significant to the fair value measurement. The presence of at least one unobservable input that has significant impact to the fair value measurement would result in classification as a Level 3 instrument. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and considers factors specific to the asset, such as the relative impact on the fair value as a result of including a particular input and market conditions. We did not make any other significant judgments except as described above.

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 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 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 benchmark yields, reported trades, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and transaction volumes, and believe that the 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 non-binding broker 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.

Other-than-temporary impairments

Investments are evaluated monthly for other-than-temporary impairment loss. Some factors considered in evaluating whether or not a decline in fair value is other-than-temporary include:

- the extent and duration for 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 based upon analysts' recommendations;
- specific events that occurred affecting the issuer, including rating downgrades;
- intent to sell or more likely than not we would be required to sell (debt securities); and

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ability and intent to retain the investment for a period of time sufficient to allow for a recovery in value (equity securities).

For available-for-sale equity securities, a charge is recorded in the Statements of Operations for positions that have experienced other-than-temporary impairments. For debt securities in which we do not expect full recovery of amortized cost, the security is deemed to be credit-impaired. Credit-related impairments and impairments on securities we intend to sell or more likely than not will be required to sell are recorded in the Statements of Operations. It is our intention to sell all debt securities with credit impairments.

### Limited partnerships

The primary basis for the valuation of limited partnership interests is 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 generally result in a quarter delay in the inclusion of the limited partnership results in our Statements of Operations. Due to this delay, these financial statements do not reflect the market conditions experienced in the fourth quarter of 2016.

The majority of our limited partnership holdings are considered investment companies where the general partners record assets at fair value. These limited partnerships are recorded using the equity method of accounting. We also own some real estate limited partnerships that do not meet the criteria of an investment company. These partnerships prepare audited financial statements on a cost basis. We have elected to report these limited partnerships under the fair value option, which is based on the net asset value (NAV) from our partner's capital statement reflecting the general partner's estimate of fair value for the fund's underlying assets. Fair value provides consistency in the evaluation and financial reporting for these limited partnerships and limited partnerships accounted for under the equity method.

We have three types of limited partnership investments: private equity, mezzanine debt, and real estate. Nearly all of the underlying investments in our limited partnerships are valued using a source other than quoted prices in active markets. The fair value amounts for our private equity and mezzanine debt partnerships are based upon the financial statements prepared by the general partners, who use various methods to estimate fair value including the market approach, income approach, and the cost approach. The market approach uses prices and other pertinent information from market-generated transactions involving identical or comparable assets or liabilities. Such valuation techniques often use market multiples derived from a set of comparables. The income approach uses valuation techniques to convert future cash flows or earnings to a single discounted present value amount. The measurement is based upon the value indicated by current market expectations about those future amounts. The cost approach is derived from the amount that is currently required to replace the service capacity of an asset. If information becomes available that would impair the cost of investments owned by the partnerships, then the general partner would adjust the investments to the net realizable value.

The fair value of investments in real estate limited partnerships is determined by the general partner based upon independent appraisals and/or internal valuations. Real estate projects under development are generally valued at cost and impairment tested by the general partner.

While we perform various procedures in review of the general partners' valuations, we rely on the general partners' financial statements as the best available information to record our share of the partnership unrealized gains and losses resulting from valuation changes. Due to the limited market for these investments, there is higher potential for variability. We survey each of the general partners quarterly about expected significant changes (plus or minus 10% compared to previous quarter) to valuations prior to the release of the fund's quarterly and annual financial statements. Based upon that information from the general partner, we consider whether additional disclosure is warranted. We analyze limited partnerships measured at fair value based upon NAV to determine if the most recently available NAV reflects fair value at the balance sheet date, with an adjustment being made where appropriate (change of plus or



minus 5% compared to most recent NAV.)

We have made no new limited partnership commitments since 2006, and the balance of limited partnership investments is expected to decline over time as additional distributions are received.

#### Retirement Benefit Plans for Employees

Our pension plans consist of a noncontributory defined benefit pension plan covering substantially all employees and an unfunded supplemental employee retirement plan ("SERP") for certain members of executive and senior management. Although we are the sponsor of these postretirement plans and record the funded status of these plans, the Exchange reimburses us for approximately 59% of the annual benefit expense of these plans, which represents pension benefits for our employees performing claims and life insurance functions and their share of service department costs.

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Our pension obligation is developed from actuarial estimates. Several statistical and other factors, which attempt to anticipate future events, are used in calculating the expense and liability related to the plans. Key factors include assumptions about the discount rates and expected rates of return on plan assets. We review these assumptions annually and modify them considering historical experience, current market conditions, including changes in investment returns and interest rates and expected future trends.

Accumulated and projected benefit obligations are expressed as the present value of future cash payments. We discount those cash payments based upon a yield curve developed from corporate bond yield information with maturities that correspond to the payment of benefits. Lower discount rates increase present values and subsequent year pension expense, while higher discount rates decrease present values and subsequent year pension expense. The construction of the yield curve is based upon yields of corporate bonds rated AA or equivalent quality. Target yields are developed from bonds at various maturity points and a curve is fitted to those targets. Spot rates (zero coupon bond yields) are developed from the yield curve and used to discount benefit payment amounts associated with each future year. The present value of plan benefits is calculated by applying the spot/discount rates to projected benefit cash flows. A single discount rate is then developed to produce the same present value. The cash flows from the yield curve were matched against our projected benefit payments in the pension plan, which have a duration of about 19 years. This yield curve supported the selection of a 4.24% discount rate for the projected benefit obligation at December 31, 2016 and for the 2017 pension expense. The same methodology was used to develop the 4.57% and 4.17% discount rates used to determine the projected benefit obligation for 2015 and 2014, respectively, and the pension expense for 2016 and 2015, respectively. A 25 basis point decrease in the discount rate assumption, with other assumptions held constant, would increase pension cost in the following year by \$3.8 million and would increase the pension benefit obligation by \$37.0 million.

Unrecognized actuarial gains and losses arise from several factors, including experience and assumption changes in the obligations and from the difference between expected returns and actual returns on plan assets. These unrecognized gains and losses are recorded in the pension plan obligation and accumulated other comprehensive income (loss) on the Statements of Financial Position. These amounts are systematically recognized to net periodic pension expense in future periods, with gains decreasing and losses increasing future pension expense. If actuarial net gains or losses exceed 5% of the greater of the projected benefit obligation and the market-related value of plan assets, the excess is recognized through the net periodic pension expense equally over the estimated service period of the employee group, which is currently 15 years.

The expected long-term rate of return for the pension plan represents the average rate of return to be earned on plan assets over the period the benefits included in the benefit obligation are to be paid. The expected long-term rate of return is less susceptible to annual revisions, as there are typically no significant changes in the asset mix. To determine the expected long-term rate of return assumption, we utilized models based upon rigorous historical analysis and forward-looking views of the financial markets based upon key factors such as historical returns for the asset class' applicable indices, the correlations of the asset classes under various market conditions and consensus views on future real economic growth and inflation. The expected future return for each asset class is then combined by considering correlations between asset classes and the volatilities of each asset class to produce a reasonable range of asset return results within which our expected long-term rate of return assumption falls. A change of 25 basis points in the expected long-term rate of return assumption, with other assumptions held constant, would have an estimated \$1.5 million impact on net pension benefit cost in the following year, of which our share would be approximately \$0.6 million. Based on a review of the key factors and expectations of future asset performance, we reduced the expected return on asset assumption from 7.00% to 6.75% for 2017.

We use a four year averaging method to determine the market-related value of plan assets, which is used to determine the expected return component of pension expense. Under this methodology, asset gains or losses that result from returns that differ from our long-term rate of return assumption are recognized in the market-related value of assets on

a level basis over a four year period. The market-related asset experience during 2016 that related to the actual investment return being different from that assumed during the prior year was a loss of \$1.5 million. Recognition of this loss will be deferred and recognized over a four year period, consistent with the market-related asset value methodology. Once factored into the market-related asset value, these experience gains and losses will be amortized over a period of 15 years, which is the remaining service period of the employee group.

Estimates of fair values of the pension plan assets are obtained primarily from our trustee and custodian of our pension plan. Our Level 1 category includes a money market fund that is a mutual fund for which the fair value is determined using an exchange traded price provided by the trustee and custodian. Our Level 2 category includes commingled pools. Estimates of fair values for securities held by our commingled pools are obtained primarily from the trustee and custodian. The methodologies used by the trustee and custodian that support a financial instrument Level 2 classification include multiple verifiable, observable inputs including benchmark yields, reported trades, broker/dealer quotes, issuers spreads, two-sided markets, benchmark securities, bids, offers, and reference data. There were no Level 3 investments in 2016 or 2015.

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We expect our net pension benefit costs to increase from \$30.6 million in 2016 to \$34.3 million in 2017 as a result of a lower discount rate and a lower assumed expected return on assets in 2017, partially offset by the mortality tables being updated with two additional years of mortality data. Our share of the net pension benefit costs after reimbursements will increase from \$12.7 million in 2016 to approximately \$14.1 million in 2017.

The actuarial assumptions we used in determining our pension obligation may differ materially from actual results due to changing market and economic conditions, higher or lower withdrawal rates, or longer or shorter life spans of participants. While we believe that the assumptions used are appropriate, differences in actual experience or changes in assumptions may materially affect our financial position, results of operations, or cash flows. See Part II, Item 8. "Financial Statements and Supplementary Data - Note 8, Postretirement Benefits, of Notes to Financial Statements" contained within this report for additional details on the pension plans.

## RESULTS OF OPERATIONS

We earn management fee revenue from providing services relating to the sales, underwriting, and issuance of policies on behalf of the Exchange as a result of its attorney-in-fact relationship. A summary of the financial results of these operations is as follows:

(dollars in thousands)	Years ended December 31,					
	2016	% Change	2015	% Change	2014	
Management fee revenue, net	\$1,567,431	6.2 %	\$1,475,511	7.2 %	\$1,376,190	
Service agreement revenue	29,200	(2.7 )	29,997	(3.0)	30,929	
Total operating revenue	1,596,631	6.1	1,505,508	7.0	1,407,119	
Total operating expenses	1,304,267	2.5	1,272,967	7.5	1,184,272	
Net revenue from operations	\$292,364	25.7 %	\$232,541	4.3 %	\$222,847	
Gross margin	18.3	% 2.9 pts.	15.4	% (0.4)pts.	15.8	%

## Management fee revenue

Management fee revenue is based upon all direct and assumed premiums written by the Exchange and the management fee rate, which is determined by our Board of Directors at least annually. Management fee revenue is calculated by multiplying the management fee rate by the direct and assumed premiums written by the Exchange. The following table presents the calculation of management fee revenue:

(dollars in thousands)	Years ended December 31,					
	2016	% Change	2015	% Change	2014	
Direct and assumed premiums written by the Exchange	\$6,278,126	6.2 %	\$5,914,045	7.3 %	\$5,513,962	
Management fee rate	25	%	25	%	25	%
Management fee revenue, gross	1,569,531	6.2	1,478,511	7.3	1,378,490	
Change in allowance for management fee returned on cancelled policies <sup>(1)</sup>	(2,100 )	NM	(3,000 )	NM	(2,300 )	
Management fee revenue, net of allowance	\$1,567,431	6.2 %	\$1,475,511	7.2 %	\$1,376,190	

NM = not meaningful

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

Direct and assumed premiums written by the Exchange

Direct and assumed premiums include premiums written directly by the Exchange and premiums assumed from its wholly owned property and casualty subsidiaries. Direct and assumed premiums written by the Exchange increased 6.2% to \$6.3 billion in 2016, from \$5.9 billion in 2015, driven by an increase in policies in force and increases in average premium per policy. Year-over-year policies in force for all lines of business increased by 3.1% in 2016 primarily as the result of continuing strong policyholder retention, compared to 3.6% in 2015. The year-over-year average premium per policy for all lines of business increased 2.9% at December 31, 2016, compared to 3.5% at December 31, 2015.

Premiums generated from new business increased 4.3% to \$753 million in 2016, compared to 3.9%, or \$722 million, in 2015. Underlying the trend in new business premiums was a 0.9% increase in new business policies written in 2016, compared to

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2.3% in 2015, while the year-over-year average premium per policy on new business increased 3.4% at December 31, 2016, compared to 1.6% at December 31, 2015.

Premiums generated from renewal business increased 6.4% to \$5.5 billion in 2016, compared to 7.7%, or \$5.2 billion, in 2015. Underlying the trend in renewal business premiums were increases in average premium per policy and steady policy retention ratios. The renewal business year-over-year average premium per policy increased 2.8% at December 31, 2016, compared to 3.8% at December 31, 2015.

The Exchange implemented rate increases in 2016, 2015, and 2014 in order to meet loss cost expectations. As the Exchange writes policies with annual terms only, rate actions take 12 months to be fully recognized in written premium and 24 months to be fully recognized in earned premiums. Since rate changes are realized at renewal, it takes 12 months to implement a rate change to all policyholders and another 12 months to earn the increased or decreased premiums in full. As a result, certain rate actions approved in 2015 were reflected in 2016, and recent rate actions in 2016 will be reflected in 2017. The Exchange continuously evaluates pricing and product offerings to meet consumer demands.

Personal lines – Total personal lines premiums written increased 6.5% to \$4.4 billion in 2016, from \$4.2 billion in 2015, driven by an increase of 3.3% in total personal lines policies in force and an increase of 3.1% in the total personal lines year-over-year average premium per policy.

Commercial lines – Total commercial lines premiums written increased 5.4%, to \$1.8 billion in 2016, compared to 2015, driven by a 2.3% increase in total commercial lines policies in force and a 3.1% increase in the total commercial lines year-over-year average premium per policy.

Future trends-premium revenue – The Exchange plans to continue its efforts to grow premiums and improve its competitive position in the marketplace. Expanding the size of its agency force through a careful agency selection process and increased market penetration in our existing operating territories will contribute to future growth as existing and new agents build their books of business

Changes in premium levels attributable to the growth in policies in force directly affects the profitability of the Exchange and has a direct bearing on our management fee. The Exchange's continued focus on underwriting discipline and the maturing of our pricing sophistication models has contributed to its growth in new policies in force, steady policy retention ratios, and increased average premium per policy. The continued growth of its policy base is dependent upon the Exchange's ability to retain existing policyholders and attract new policyholders. A lack of new policy growth or the inability to retain existing customers could have an adverse effect on the Exchange's premium level growth, and consequently our management fee.

Changes in premium levels attributable to rate changes also directly affect the profitability of the Exchange and have a direct bearing on our management fee. Pricing actions contemplated or taken by the Exchange are subject to various regulatory requirements of the states in which it operates. The pricing actions already implemented, or to be implemented, have an effect on the market competitiveness of the Exchange's insurance products. Such pricing actions, and those of the Exchange's competitors, could affect the ability of the Exchange's agents to retain and attract new business. We expect the Exchange's pricing actions to result in a net increase in direct written premium in 2017; however, exposure reductions and/or changes in mix of business as a result of economic conditions could impact the average premium written and assumed by the Exchange, as customers may reduce coverages.

### Management fee rate

The management fee rate was set at 25%, the maximum rate, for 2016, 2015 and 2014. The management fee rate for 2017 was set at 25% by our Board of Directors. Changes in the management fee rate can affect our revenue and net

income significantly. See also, the "Transactions/Agreements with Related Parties" section within this report.

Change in allowance for management fee returned on cancelled policies

Management fees are returned to the Exchange when policyholders cancel their insurance coverage mid-term and unearned premiums are refunded to them. We maintain an allowance for management fees returned on mid-year policy cancellations that recognizes the management fee anticipated to be returned to the Exchange based on historical mid-term cancellation experience. Our cash flows are unaffected by the recording of this allowance.

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## Service agreement revenue

Service agreement revenue includes service charges we collect from policyholders for providing extended payment terms on policies written and assumed by the Exchange, and late payment and policy reinstatement fees. The service charges are fixed dollar amounts per billed installment. Service agreement revenue totaled \$29.2 million, \$30.0 million and \$30.9 million in 2016, 2015 and 2014, respectively. The decrease in service agreement revenue compared to the growth in policies in force reflects the continued shift in policies to the monthly direct debit payment plan, which does not incur service charges, and the no-fee single payment plan, which offers a premium discount. The shift to these plans is driven by the consumers' desire to avoid paying service charges and to take advantage of the discount in pricing offered for paid-in-full policies.

## Cost of management operations

(dollars in thousands)	Years ended December 31,					
	2016	% Change	2015	% Change	2014	
<b>Commissions:</b>						
Total commissions	\$893,800	5.4 %	\$847,880	8.3 %	\$783,017	
<b>Non-commission expense:</b>						
Underwriting and policy processing	\$135,855	0.8 %	\$134,837	6.4 %	\$126,779	
Information technology	121,249	(1.7 )	123,362	1.9	121,094	
Sales and advertising	63,423	(1.5 )	64,403	6.7	60,334	
Customer service	24,604	(16.1)	29,325	10.6	26,522	
Administrative and other	65,336	(10.7)	73,160	10.0	66,526	
Total non-commission expense	410,467	(3.4 )	425,087	5.9	401,255	
Total cost of management operations	\$1,304,267	2.5 %	\$1,272,967	7.5 %	\$1,184,272	

Commissions – Commissions increased \$45.9 million in 2016 compared to 2015 as a result of the 6.2% increase in direct and assumed premiums written by the Exchange. In 2015, commissions increased \$64.9 million, or 8.3%, compared to 2014, primarily as a result of the 7.3% increase in the direct and assumed premiums written by the Exchange, while the remaining portion of the increase was due to higher agent incentive costs related to profitable growth.

Non-commission expense – Non-commission expense decreased \$14.6 million in 2016 compared to 2015. Information technology costs decreased \$2.1 million primarily due to decreased personnel costs somewhat offset by an increase in professional fees. Customer service costs decreased \$4.7 million primarily due to decreased credit card processing fees and personnel costs. Administrative and other costs decreased \$7.8 million due to decreased personnel costs, including incentive compensation forfeited by senior executives who separated from service during 2016, somewhat offset by an increase in professional fees. Personnel costs in all expense categories were impacted by decreased pension costs primarily due to an increase in the pension discount rate as well as decreased medical costs.

In 2015, compared to 2014, non-commission expense increased \$23.8 million. Underwriting and policy processing costs increased \$8.0 million due to increased personnel and postage costs. Information technology costs increased \$2.3 million primarily due to hardware and software costs. Sales and advertising costs increased \$4.1 million primarily due to personnel costs. Customer service costs increased \$2.8 million due to an increase in personnel costs and credit card processing fees. Administrative and other costs increased \$6.6 million due to personnel costs and professional fees. Personnel costs in all expense categories were impacted by increased pension and medical costs, and increased estimates for incentive plan compensation costs related to underwriting performance.

## Gross margin

The gross margin in 2016 was 18.3%, compared to 15.4% in 2015 and 15.8% in 2014.





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## Total investment income

A summary of the results of our investment operations is as follows for the years ended December 31:

(dollars in thousands)	2016	% Change	2015	% Change	2014
Net investment income	\$20,547	15.5 %	\$17,791	7.6 %	\$16,536
Net realized investment gains	672	36.5	492	(53.4)	1,057
Net impairment losses recognized in earnings	(416 )	NM	(1,558 )	NM	(105 )
Equity in earnings of limited partnerships	7,025	(58.6)	16,983	55.4	10,929
Total investment income	\$27,828	(17.4)%	\$33,708	18.6 %	\$28,417

NM = not meaningful

## Net investment income

Net investment income primarily includes interest and dividends on our fixed maturity and equity security portfolios.

Net investment income increased by \$2.8 million in 2016, compared to 2015, and increased by \$1.3 million in 2015, compared to 2014. The increases in net investment income in both 2016 and 2015 were primarily attributable to income from fixed maturity investments, reflecting higher invested balances and investment yields, partially offset by lower income from equity securities as a result of the sale of our preferred stock holdings in the fourth quarter of 2015.

## Net realized investment gains

A breakdown of our net realized investment gains (losses) is as follows for the years ended December 31:

(in thousands)	2016	2015	2014
Securities sold:			
Fixed maturities	\$(2 )	\$(193)	\$120
Equity securities	(33 )	685	937
Common stock trading securities	707	0	0
Total net realized investment gains <sup>(1)</sup>	\$672	\$492	\$1,057

<sup>(1)</sup> See Part II, Item 8. "Financial Statements and Supplementary Data – Note 5, Investments, of Notes to Financial Statements" contained within this report for additional disclosures regarding net realized investment gains (losses).

Net realized investment gains and losses include gains and losses resulting from the sales of our fixed maturity or equity securities.

Net realized gains were \$0.7 million in 2016, compared to gains of \$0.5 million in 2015 and \$1.1 million in 2014. Net realized gains in 2016 were primarily attributable to gains from sales of common stock trading securities. Net realized gains in 2015 were due to gains from sales on nonredeemable preferred stock, which were partially offset by losses from sales of fixed maturities, while gains in 2014 were primarily attributable to gains from sales of equity securities.

## Net impairment losses recognized in earnings

Net impairment losses recognized in earnings were \$0.4 million in 2016, compared to \$1.6 million in 2015, and \$0.1 million in 2014. Net impairment losses recognized in earnings in both 2016 and 2015 were primarily due to securities in an unrealized loss position where we determined the loss was other-than-temporary based on credit factors, and also

included securities in an unrealized loss position that we intended to sell prior to expected recovery to our cost basis.

Equity in earnings of limited partnerships

The components of equity in earnings of limited partnerships are as follows for the years ended December 31:

(in thousands)	2016	2015	2014
Private equity	\$(2,756)	\$12,169	\$4,060
Mezzanine debt	51	1,788	1,882
Real estate	9,730	3,026	4,987
Total equity in earnings of limited partnerships	\$7,025	\$16,983	\$10,929

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

Limited partnership earnings tend to be cyclical based upon market conditions, the age of the partnership, and the nature of the investments. Generally, limited partnership earnings are recorded on a quarter lag from financial statements we receive from our general partners. As a consequence, earnings from limited partnerships reported at December 31, 2016 reflect investment valuation changes resulting from the financial markets and the economy for the twelve month period ending September 30, 2016.

Equity in earnings of limited partnerships decreased by \$10.0 million in 2016, compared to 2015, and increased by \$6.1 million in 2015, compared to 2014. The decrease in earnings in 2016 was the result of lower earnings from private equity investments that were partially offset by higher earnings from real estate investments. The increase in earnings in 2015 was due to higher earnings from private equity investments that were partially offset by lower earnings from real estate investments.

Financial Condition of Erie Insurance Exchange

Serving in the capacity of attorney-in-fact for the Exchange, we are dependent on the growth and financial condition of the Exchange, who is our sole customer. The strength of the Exchange and its wholly owned subsidiaries is rated annually by A.M. Best Company. Higher ratings of insurance companies generally indicate financial stability and a strong ability to pay claims. The ratings are generally based upon factors relevant to policyholders and are not directed toward return to investors. The Exchange and each of its property and casualty subsidiaries are rated A+ "Superior". The outlook for the financial strength rating is stable. According to A.M. Best, this second highest financial strength rating category is assigned to those companies that, in A.M. Best's opinion, have achieved superior overall performance when compared to the standards established by A.M. Best and have a superior ability to meet obligations to policyholders over the long term. Only approximately 11% of insurance groups are rated A+ or higher, and the Exchange is included in that group.