ERIE INDEMNITY CO
Form 10-Q
May 02, 2019

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

FORM 10-Q

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

For the quarterly period ended March 31, 2019

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).
Yes [X]   No [ ]

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

Large accelerated filer [X]   Accelerated filer [ ]   Non-accelerated filer [ ]

Smaller reporting company [ ]   Emerging growth company [ ]

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange
Act. [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes [ ] No [X]

The number of shares outstanding of the registrant's Class A Common Stock as of the latest practicable date, with no par value and a stated value of $0.0292 per share, was 46,189,068 at April 12, 2019.

The number of shares outstanding of the registrant's Class B Common Stock as of the latest practicable date, with no par value and a stated value of $70 per share, was 2,542 at April 12, 2019.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	Three Months Ended March 31,	
	2019	2018
Operating revenue		
Management fee revenue - policy issuance and renewal services, net	$430,983	$405,978
Management fee revenue - administrative services, net	13,951	13,074
Administrative services reimbursement revenue	142,480	145,963
Service agreement revenue	6,692	7,145
Total operating revenue	594,106	572,160
Operating expenses		
Cost of operations - policy issuance and renewal services	365,504	348,630
Cost of operations - administrative services	142,480	145,963
Total operating expenses	507,984	494,593
Operating income	86,122	77,567
Investment income		
Net investment income	8,517	6,820
Net realized investment gains (losses)	2,503	(465)
Net impairment losses recognized in earnings	(78)	0
Equity in losses of limited partnerships	(1,147)	(192)
Total investment income	9,795	6,163
Interest expense, net	449	553
Other income	47	44
Income before income taxes	95,515	83,221
Income tax expense	20,204	17,463
Net income	$75,311	$65,758
Net income per share		
Class A common stock – basic	$1.62	$1.41
Class A common stock – diluted	$1.44	$1.26
Class B common stock – basic and diluted	$243	$212
Weighted average shares outstanding – Basic		
Class A common stock	46,188,337	46,187,908
Class B common stock	2,542	2,542
Weighted average shares outstanding – Diluted		
Class A common stock	52,312,036	52,310,628

Class B common stock	2,542	2,542
Dividends declared per share		
Class A common stock	$0.90	$0.84
Class B common stock	$135.00	$126.00

See accompanying notes to Financial Statements. See Note 12, "Accumulated Other Comprehensive Income (Loss)", for amounts reclassified out of accumulated other comprehensive income (loss) into the Statements of Operations.

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ERIE INDEMNITY COMPANY
STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(in thousands)

	Three Months Ended March 31,	
	2019	2018
Net income	$75,311	$65,758
Other comprehensive income (loss), net of tax		
Change in unrealized holding gains (losses) on available-for-sale securities	5,478	(5,427)
Amortization of prior service costs and net actuarial loss on pension and other postretirement plans	1,232	0
Total other comprehensive income (loss), net of tax	6,710	(5,427)
Comprehensive income	$82,021	$60,331

See accompanying notes to Financial Statements. See Note 12, "Accumulated Other Comprehensive Income (Loss)", for amounts reclassified out of accumulated other comprehensive income (loss) into the Statements of Operations.

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

	March 31, 2019 (Unaudited)	December 31, 2018
Assets		
Current assets:		
Cash and cash equivalents	$312,045	$266,417
Available-for-sale securities	139,994	402,339
Receivables from Erie Insurance Exchange and affiliates	456,135	449,873
Prepaid expenses and other current assets	49,997	36,892
Federal income taxes recoverable	0	8,162
Accrued investment income	4,220	5,263
Total current assets	962,391	1,168,946
Available-for-sale securities	534,925	346,184
Equity securities	12,410	11,853
Limited partnership investments	30,038	34,821
Fixed assets, net	144,652	130,832
Deferred income taxes, net	22,180	24,101
Other assets	92,860	61,590
Total assets	$1,799,456	$1,778,327
Liabilities and shareholders' equity		
Current liabilities:		
Commissions payable	$253,002	$241,573
Agent bonuses	26,129	103,462
Accounts payable and accrued liabilities	123,179	111,291
Dividends payable	41,913	41,910
Contract liability	34,116	33,854
Deferred executive compensation	10,346	13,107
Federal income taxes payable	11,946	0
Current portion of long-term borrowings	1,891	1,870
Total current liabilities	502,522	547,067
Defined benefit pension plans	123,270	116,866
Long-term borrowings	97,382	97,860
Contract liability	17,907	17,873
Deferred executive compensation	16,817	13,075
Other long-term liabilities	27,754	11,914
Total liabilities	785,652	804,655
Shareholders’ equity		
Class A common stock, stated value $0.0292 per share; 74,996,930 shares authorized; 68,299,200 shares issued; 46,189,068 shares outstanding	1,992	1,992
Class B common stock, convertible at a rate of 2,400 Class A shares for one Class B share, stated value $70 per share; 3,070 shares authorized; 2,542 shares issued and	178	178

outstanding		
Additional paid-in-capital	16,483	16,459
Accumulated other comprehensive loss	(123,574)	(130,284)
Retained earnings	2,264,815	2,231,417
Total contributed capital and retained earnings	2,159,894	2,119,762
Treasury stock, at cost; 22,110,132 shares held	(1,158,779)	(1,157,625)
Deferred compensation	12,689	11,535
Total shareholders’ equity	1,013,804	973,672
Total liabilities and shareholders’ equity	$ 1,799,456	$ 1,778,327

See accompanying notes to Financial Statements.

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ERIE INDEMNITY COMPANY
STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)
Three months ended March 31, 2019 and 2018
(dollars in thousands, except per share data)

	Class A common stock	Class B common stock	Additional paid-in-capital	Accumulated other comprehensive income (loss)	Retained earnings	Treasury stock	Deferred compensation	Total shareholders' equity
Balance, December 31, 2018	$ 1,992	$ 178	$ 16,459	$ (130,284)	$ 2,231,417	$ (1,157,625)	$ 11,535	$ 973,672
Net income					75,311			75,311
Other comprehensive income				6,710				6,710
Dividends declared:								
Class A $0.90 per share					(41,570)			(41,570)
Class B $135.00 per share					(343)			(343)
Net purchase of treasury stock (1)			24			0		24
Deferred compensation						(1,154)	1,154	0
Balance, March 31, 2019	$ 1,992	$ 178	$ 16,483	$ (123,574)	$ 2,264,815	$ (1,158,779)	$ 12,689	$ 1,013,804

	Class A common stock	Class B common stock	Additional paid-in-capital	Accumulated other comprehensive income (loss)	Retained earnings	Treasury stock	Deferred compensation	Total shareholders' equity
Balance, December 31, 2017	$ 1,992	$ 178	$ 16,470	$ (156,059)	$ 2,140,853	$ (1,155,668)	$ 9,578	$ 857,344
Cumulative effect adjustments (2)					(38,392)			(38,392)
Net income					65,758			65,758
Other comprehensive loss				(5,427)				(5,427)
Dividends declared:								
Class A $0.84 per share					(38,799)			(38,799)
Class B $126.00 per share					(320)			(320)
Net purchase of treasury stock (1)			(9)			0		(9)
Deferred compensation						(1,663)	1,663	0
Balance, March 31, 2018	$ 1,992	$ 178	$ 16,461	$ (161,486)	$ 2,129,100	$ (1,157,331)	$ 11,241	$ 840,155

(1) Net purchases of treasury stock in 2019 and 2018 include the repurchase of our Class A common stock in the open market that were subsequently distributed to satisfy stock based compensation awards. See Note 11, "Capital Stock", for additional information on treasury stock transactions.
(2) Cumulative effect adjustments are primarily related to the implementation of new revenue recognition guidance effective January 1, 2018.

See accompanying notes to Financial Statements.

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ERIE INDEMNITY COMPANY
STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	Three Months Ended March 31, 2019		2018	
Cash flows from operating activities				
Management fee received	$ 433,735		$ 418,897	
Administrative services reimbursements received	148,308		150,422	
Service agreement fee received	6,692		7,145	
Net investment income received	9,112		8,951	
Limited partnership distributions	1,225		426	
Commissions paid to agents	(204,633	)	(192,803	)
Agents bonuses paid	(104,689	)	(122,607	)
Salaries and wages paid	(50,840	)	(54,668	)
Pension contributions and employee benefits paid	(10,875	)	(49,199	)
General operating expenses paid	(60,439	)	(59,033	)
Administrative services expenses paid	(143,046	)	(146,935	)
Income taxes recovered (paid)	138		(276	)
Interest paid	(448	)	(550	)
Net cash provided by (used in) operating activities	24,240		(40,230	)
Cash flows from investing activities				
Purchase of investments:				
Available-for-sale securities	(220,811	)	(77,263	)
Equity securities	0		(1,035	)
Limited partnerships	(9	)	(31	)
Proceeds from investments:				
Available-for-sale securities sales	149,155		57,717	
	154,343		28,473	

Available-for-sale securities maturities/calls		
Equity securities	0	1,055
Limited partnerships	2,411	910
Purchase of fixed assets	(17,411)	(8,691)
Distributions on agent loans	(6,233)	(19,310)
Collections on agent loans	2,313	1,436
Net cash provided by (used in) investing activities	63,758	(16,739)
Cash flows from financing activities		
Dividends paid to shareholders	(41,910)	(39,116)
Net payments on long-term borrowings	(460)	(9)
Net cash used in financing activities	(42,370)	(39,125)
Net increase (decrease) in cash and cash equivalents	45,628	(96,094)
Cash and cash equivalents, beginning of period	266,417	215,721
Cash and cash equivalents, end of period	$ 312,045	$ 119,627
Supplemental disclosure of noncash transactions		
Operating lease assets obtained in exchange for new operating lease liabilities	$ 32,515	$ —

See accompanying notes to Financial Statements.

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NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Nature of Operations

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.

Our primary function as attorney-in-fact is to perform policy issuance and renewal services on behalf of the subscribers at the Exchange. We also act as attorney-in-fact on behalf of the Exchange with respect to all claims handling and investment management services, as well as the service provider for all claims handling, life insurance, and investment management services for its insurance subsidiaries, collectively referred to as "administrative services". Acting as attorney-in-fact in these two capacities 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. Pursuant to the subscriber's agreement for acting as attorney-in-fact in these two capacities, we earn a management fee calculated as a percentage of the direct and affiliated assumed premiums written by the Exchange.

The policy issuance and renewal 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. The underwriting services we provide include underwriting and policy processing. The remaining services we provide include customer service and administrative support. We also provide information technology services that support all the functions listed above. Included in these expenses are allocations of costs for departments that support these policy issuance and renewal functions.

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. Claims handling services include costs incurred in the claims process, including the adjustment, investigation, defense, recording and payment functions. Life insurance management services include costs incurred in the management and processing of life insurance business. Investment management services are related to investment trading activity, accounting and all other functions attributable to the investment of funds. Included in these expenses are allocations of costs for departments that support these administrative functions. The amounts incurred for these services are reimbursed to Indemnity at cost in accordance with the subscriber's agreement and the service agreements. State insurance regulations require that intercompany service agreements and any material amendments be approved in advance by the state insurance department.

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 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 and cost reimbursements. See Note 13, "Concentrations of Credit Risk".

Note 2. Significant Accounting Policies

Basis of presentation

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2019 are not necessarily indicative of the results that may be expected for the year ending December 31, 2019. For further information, refer to the financial statements and footnotes included in our Form 10-K for the year ended December 31, 2018 as filed with the Securities and Exchange Commission on February 21, 2019.

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

Recently adopted accounting standards
In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Codification ("ASC") 842, "Leases", which requires lessees to recognize assets and liabilities arising from operating leases on the Statements of Financial Position and to disclose certain information about leasing arrangements. We adopted ASC 842 on January 1, 2019 using the optional transition method, which permits entities to apply the new guidance prospectively with certain practical expedients available. We elected the package of practical expedients which among other things allowed us to carry forward the historical lease classifications. We did not elect the hindsight practical expedient in determining the lease term for existing leases.

The adoption of the new standard resulted in the recognition of operating lease assets of $32.7 million and operating lease liabilities of $32.1 million on the Statement of Financial Position at January 1, 2019. The adoption of this standard did not have a material impact on our Statement of Operations and had no impact on our net cash flows.

Recently issued accounting standards
In August 2018, the FASB issued Accounting Standards Update ("ASU") 2018-15, "Intangibles-Goodwill and Other Internal-Use Software", which aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. ASU 2018-15 is effective for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. The amendments under ASU 2018-15 may be applied either retrospectively or prospectively to all implementation costs incurred after the date of adoption and early adoption is permitted. We plan to adopt this guidance on a prospective basis and do not expect a material impact on our financial statements or disclosures.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments-Credit Losses", which requires financial assets measured at amortized cost to be presented at the net amount expected to be collected through the use of a new forward-looking expected loss model and credit losses relating to available-for-sale debt securities to be recognized through an allowance for credit losses. ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019. Early adoption for interim and annual periods beginning after December 15, 2018 is permitted. We have evaluated the impact of this guidance on our invested assets. Our investments are not measured at amortized cost, and therefore do not require the use of a new expected loss model. Our available-for-sale debt securities will continue to be monitored for credit losses which would be reflected as an allowance for credit losses rather than a reduction of the carrying value of the asset. Other financial assets subject to this guidance include our receivables from Erie Insurance Exchange and its subsidiaries and agent loans. Given the financial strength of the Exchange, demonstrated by its strong surplus position and industry ratings, it is unlikely these receivables would have significant, if any, credit loss exposure. Accordingly, we do not expect a material impact on our financial statements or related disclosures as a result of this guidance.

Other assets
Other assets include agent loans, operating lease assets and other long-term prepaid assets. Agent loans are carried at unpaid principal balance with interest recorded in investment income as earned. It is our policy to charge the loans that are in default directly to expense. We do not record an allowance for credit losses on these loans, as the majority of the loans are senior secured and historically have had insignificant default amounts.

The determination of whether an arrangement is a lease, and the related lease classification, is made at inception of a contract. Our leases are classified as operating leases. Operating lease assets and liabilities are recorded at inception based on the present value of the future minimum lease payments over the lease term at commencement date. When an implicit rate for the lease is not available, we use our incremental borrowing rate based on the information available at commencement date to determine the present value of future payments. Lease terms include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Most of our lease contracts contain lease and non-lease components. Non-lease components are expensed as incurred. Operating lease assets are included in other assets, and the current and noncurrent portions of the operating lease liabilities are included in accounts payable and accrued expenses and other long-term liabilities, respectively, in the Statement of Financial Position.

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Note 3. Revenue

The majority of our revenue is derived from the subscriber’s agreement between us and the subscribers (policyholders) at the Exchange. Pursuant to the subscriber’s agreement, we earn a management fee calculated as a percentage, not to exceed 25%, of all direct and affiliated assumed written premiums of the Exchange.
We allocate a portion of our management fee revenue, currently 25% of the direct and affiliated assumed written premiums of the Exchange, between the two performance obligations we have under the subscriber’s agreement. The first performance obligation is to provide policy issuance and renewal services to the subscribers (policyholders) at the Exchange, and the second is to act as attorney-in-fact on behalf of the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all administrative services. The transaction price, including management fee revenue and administrative service reimbursement revenue, is allocated based on the estimated standalone selling prices developed using industry information and other available information for similar services. We update the transaction price allocation annually based upon the most recent information available. There was no material change to the allocation in 2019.

The first performance obligation is to provide policy issuance and renewal services that result in executed insurance policies between the Exchange or one of its insurance subsidiaries and the subscriber (policyholder). Our customer, the subscriber (policyholder), receives economic benefits when substantially all the policy issuance or renewal services are complete and an insurance policy is issued or renewed by the Exchange or one of its insurance subsidiaries. It is at the time of policy issuance or renewal that the allocated portion of revenue is recognized.

The Exchange, by virtue of its legal structure as a reciprocal insurer, does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services in accordance with the subscriber's agreement. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. Collectively, these services represent a second performance obligation under the subscriber’s agreement and the service agreements. The revenue allocated to this performance obligation is recognized over time as these services are provided. The portion of revenue not yet earned is recorded as a contract liability in the Statements of Financial Position. The administrative services expenses we incur and the related reimbursements we receive are recorded gross in the Statements of Operations.

Indemnity records a receivable from the Exchange for management fee revenue when the premium is written or assumed by the Exchange. Indemnity collects the management fee from the Exchange when the Exchange collects the premiums from the subscribers (policyholders). As the Exchange issues policies with annual terms only, cash collections generally occur within one year.

A constraining estimate exists around the management fee received as consideration related to the potential for management fee to be returned if a policy were to be cancelled mid-term. 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 estimated allowance to reduce the management fee to its estimated net realizable value to account for the potential of mid-term policy cancellations based on historical cancellation rates. This estimated allowance has been allocated between the two performance obligations consistent with the revenue allocation proportions.

The following table disaggregates revenue by our two performance obligations:

	Three months ended March 31,	
(in thousands)	2019	2018
Management fee revenue - policy issuance and renewal services, net	$430,983	$405,978

Management fee revenue - administrative services, net	13,951	13,074
Administrative services reimbursement revenue	142,480	145,963
Total administrative services	$156,431	$159,037

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Note 4. Earnings Per Share

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

Class A diluted earnings per share are calculated under the if-converted method, which reflects the conversion of Class B shares to Class A shares. Diluted earnings per share calculations include the dilutive effect of assumed issuance of stock-based awards under compensation plans that have the option to be paid in stock using the treasury stock method.

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

	Three months ended March 31,					
	2019			2018		
(dollars in thousands, except per share data)	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount
Class A – Basic EPS:						
Income available to Class A stockholders	$74,694	46,188,337	$ 1.62	$65,220	46,187,908	$ 1.41
Dilutive effect of stock-based awards	0	22,899	—	0	21,920	—
Assumed conversion of Class B shares	617	6,100,800	—	538	6,100,800	—
Class A – Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	$75,311	52,312,036	$ 1.44	$65,758	52,310,628	$ 1.26
Class B – Basic and diluted EPS:						
Income available to Class B stockholders	$617	2,542	$ 243	$538	2,542	$ 212

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Note 5. Fair Value

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

Valuation techniques used to derive the fair value of our available-for-sale debt securities and equity securities are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect our own assumptions regarding fair market value for these securities. Although virtually all of our prices are obtained from third party sources, we also perform an internal pricing review on outliers. The outlier review includes securities with price changes that vary from current market conditions or independent third party price sources. Financial instruments are categorized based upon the following characteristics or inputs to the valuation techniques:

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

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

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

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

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

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

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

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The following tables present our fair value measurements on a recurring basis by asset class and level of input:

	At March 31, 2019			
	Fair value measurements using:			
(in thousands)	Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
Available-for-sale securities:				
U.S. Treasury [1]	$ 279,956	$ 0	$ 279,956	$ 0
States & political subdivisions [1]	27,452	0	27,452	0
Corporate debt securities	233,017	0	221,494	11,523
Residential mortgage-backed securities	6,571	0	5,656	915
Commercial mortgage-backed securities	48,144	0	46,962	1,182
Collateralized debt obligations	63,932	0	63,932	0
Other debt securities	15,847	0	15,847	0
Total available-for-sale securities	674,919	0	661,299	13,620
Equity securities:				
Nonredeemable preferred stock - financial services sector	12,410	1,966	10,444	0
Total equity securities	12,410	1,966	10,444	0
Total	$ 687,329	$ 1,966	$ 671,743	$ 13,620

	At December 31, 2018			
	Fair value measurements using:			
(in thousands)	Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
Available-for-sale securities:				
U.S. Treasury [1]	$ 208,412	$ 0	$ 208,412	$ 0
States & political subdivisions [1]	159,023	0	159,023	0
Corporate debt securities	249,947	0	237,370	12,577
Residential mortgage-backed securities	4,609	0	4,609	0
Commercial mortgage-backed securities	46,515	0	46,515	0
Collateralized debt obligations	64,239	0	64,239	0
Other debt securities	15,778	0	15,778	0
Total available-for-sale securities	748,523	0	735,946	12,577
Equity securities:				
Nonredeemable preferred stock - financial services sector	11,853	1,809	10,044	0
Total equity securities	11,853	1,809	10,044	0
Other limited partnership investments [2]	3,206	—	—	—
Total	$ 763,582	$ 1,809	$ 745,990	$ 12,577

(1) In the fourth quarter of 2018, we began selling off our municipal bonds as part of a portfolio rebalancing. We intend to sell the remaining municipal bonds in the second quarter of 2019. We have currently invested proceeds from these sales primarily in U.S. Treasuries.

(2) The limited partnership investment measured at fair value represents one real estate fund included on the balance sheet as a limited partnership investment reported under the fair value option using the net asset value (NAV) practical expedient, which is not required to be categorized in the fair value hierarchy. The fair value of this investment is based on our proportionate share of the NAV from the most recent partners' capital statements received from the general partner, which is generally one quarter prior to our balance sheet date. We consider observable market data and perform a review validating the appropriateness of the NAV at each balance sheet date. Liquidation of this fund was completed in January 2019. There were no unfunded commitments related to the investment at December 31, 2018. During the three months ended March 31, 2019, distributions totaling $3.2 million were received from this investment. During the year ended December 31, 2018, no contributions were made and distributions totaling $1.2 million were received from this investment.

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The following table presents our fair value measurements on a recurring basis by pricing source:

	At March 31, 2019			
(in thousands)	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
Priced via pricing services	$673,729	$0	$661,299	$12,430
Priced via market comparables/broker quotes	125	0	0	125
Priced via internal modeling	1,065	0	0	1,065
Total available-for-sale securities	674,919	0	661,299	13,620
Equity securities priced via pricing services	12,410	1,966	10,444	0
Total	$687,329	$1,966	$671,743	$13,620

Quantitative and Qualitative Disclosures about Unobservable Inputs

The following table presents quantitative information about the significant unobservable inputs utilized in the fair value measurements of Level 3 assets. Level 3 securities where cost is the best estimate of fair value totaled $1.1 million at March 31, 2019 and are excluded from the table below. When a non-binding broker quote was the only input available, the security was classified within Level 3. The quantitative detail of the unobservable inputs is neither provided nor reasonably available to us and therefore has not been included in the table below. These investments totaled $0.1 million at March 31, 2019 and $12.6 million at December 31, 2018. The weighted average is calculated based on estimated fair value.

	At March 31, 2019					
(dollars in thousands)	Fair value	Valuation techniques	Unobservable input	Range (basis points)	Weighted average (basis points)	Impact of increase in input on estimated fair value
Corporate debt securities - bank loans	$11,373	Market approach	Market residual yield (1)	-186 - +1,479	+33	Decrease
Commercial mortgage-backed securities	1,057	Market approach	Credit spread (2)	+42 - +275	+181	Decrease

(1) Values for bank loans classified as Level 3 are determined by our pricing vendor based on model yield curves adjusted for observable inputs. The market residual yield represents a net adjustment to the model yield curve for unobservable input factors.

(2) Values for commercial mortgage-backed securities classified as Level 3 include adjustments to the base spread over the appropriate U.S. Treasury yield assuming no prepayments until penalty provisions have expired.

We review the fair value hierarchy classifications each reporting period. Transfers between hierarchy levels may occur due to changes in available market observable inputs.

Level 3 Assets – Year-to-Date Change:

(in thousands)	Beginning balance at December 31, 2018	Included in earnings(1)	Included in other comprehensive income	Purchases	Sales	Transfers into Level 3(2)	Transfers out of Level 3(2)	Ending balance at March 31, 2019

Available-for-sale securities:								
Corporate debt securities	$ 12,577	$ 11	$ 268	$ 734	$ (431)	$ 4,813	$ (6,449)	$ 11,523
Residential mortgage-backed securities	0	0	0	921	(6)	0	0	915
Commercial mortgage-backed securities	0	(2)	0	478	0	706	0	1,182
Total Level 3 available-for-sale securities	$ 12,577	$ 9	$ 268	$ 2,133	$ (437)	$ 5,519	$ (6,449)	$ 13,620

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Level 3 Assets – Year-to-Date Change:

(in thousands)	Beginning balance at December 31, 2017	Included in earnings[(1)]	Included in other comprehensive income	Purchases	Sales	Transfers into Level 3[(2)]	Transfers out of Level 3[(2)]	Ending balance at March 31, 2018
Available-for-sale securities:								
Corporate debt securities	$ 7,879	$ (9)	$ 5	$ 0	$(493)	$ 2,412	$(3,485)	$ 6,309
Collateralized debt obligations	2,200	0	7	0	0	0	(2,207)	0
Total Level 3 available-for-sale securities	$ 10,079	$ (9)	$ 12	$ 0	$(493)	$ 2,412	$(5,692)	$ 6,309

(1) These amounts are reported in the Statements of Operations as net investment income and net realized investment gains (losses) for the each of the periods presented above.

(2) Transfers into and/or (out) of Level 3 are primarily attributable to the availability of market observable information and the re-evaluation of the observability of pricing inputs.

The change in unrealized gains or losses included in other comprehensive income related to Level 3 securities held at the reporting date is as follows:

(in thousands)	Three months ended March 31, 2019	2018
Available-for-sale securities:		
Corporate debt securities	$157	$ 10
Residential mortgage-backed securities	0	—
Commercial mortgage-backed securities	4	—
Net unrealized gains on Level 3 securities held at reporting date	$161	$ 10

Financial instruments disclosed, but not carried at fair value

The following table presents the carrying values and fair value measurements, which are categorized as Level 3 in the fair value hierarchy, of financial instruments disclosed, but not carried at fair value:

(in thousands)	At March 31, 2019 Carrying value	Fair value	At December 31, 2018 Carrying value	Fair value
Agent loans	$61,926	$61,487	$58,006	$54,110
Long-term borrowings	99,273	95,958	99,730	94,057

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Note 6. Investments

Available-for-sale securities

The following tables summarize the cost and fair value of our available-for-sale securities. See also Note 5, "Fair Value" for additional fair value disclosures.

(in thousands)	At March 31, 2019 Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Available-for-sale securities:				
U.S. Treasury [1]	$279,553	$ 503	$ 100	$279,956
States & political subdivisions [1]	26,931	521	0	27,452
Corporate debt securities	235,546	985	3,514	233,017
Residential mortgage-backed securities	6,513	67	9	6,571
Commercial mortgage-backed securities	48,120	273	249	48,144
Collateralized debt obligations	64,432	17	517	63,932
Other debt securities	15,752	95	0	15,847
Total available-for-sale securities	$676,847	$ 2,461	$ 4,389	$674,919

(in thousands)	At December 31, 2018 Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Available-for-sale securities:				
U.S. Treasury [1]	$208,610	$ 18	$ 216	$208,412
States & political subdivisions [1]	157,003	2,020	0	159,023
Corporate debt securities	259,362	139	9,554	249,947
Residential mortgage-backed securities	4,603	38	32	4,609
Commercial mortgage-backed securities	47,022	80	587	46,515
Collateralized debt obligations	65,039	30	830	64,239
Other debt securities	15,756	33	11	15,778
Total available-for-sale securities	$757,395	$ 2,358	$ 11,230	$748,523

(1) In the fourth quarter of 2018, we began selling off our municipal bonds as part of a portfolio rebalancing. We intend to sell the remaining municipal bonds in the second quarter of 2019. We have currently invested proceeds from these sales primarily in U.S. Treasuries.

The amortized cost and estimated fair value of available-for-sale securities at March 31, 2019 are shown below by remaining contractual term to maturity. Mortgage-backed securities are allocated based upon stated maturity dates. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(in thousands)	At March 31, 2019 Amortized cost	Estimated fair value
Due in one year or less	$123,334	$123,200
Due after one year through five years	320,044	319,564
Due after five years through ten years	133,675	132,586
Due after ten years	99,794	99,569
Total available-for-sale securities [1]	$676,847	$674,919

(1) The contractual maturities of our municipal bond portfolio are included in the table. However, given our intent to sell this portfolio, municipal bond securities are classified as current assets in our Statements of Financial Position.

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

(dollars in thousands)	At March 31, 2019						
	Less than 12 months		12 months or longer		Total		
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses	No. of holdings
Available-for-sale securities:							
U.S. Treasury	$0	$ 0	$ 11,748	$ 100	$ 11,748	$ 100	4
Corporate debt securities	82,879	1,647	94,393	1,867	177,272	3,514	471
Residential mortgage-backed securities	1,208	4	388	5	1,596	9	2
Commercial mortgage-backed securities	9,491	17	19,023	232	28,514	249	27
Collateralized debt obligations	59,394	468	3,231	49	62,625	517	45
Other debt securities	100	0	0	0	100	0	1
Total available-for-sale securities	$ 153,072	$ 2,136	$ 128,783	$ 2,253	$ 281,855	$ 4,389	550
Quality breakdown of available-for-sale securities:							
Investment grade	$ 77,871	$ 534	$ 94,217	$ 807	$ 172,088	$ 1,341	124
Non-investment grade	75,201	1,602	34,566	1,446	109,767	3,048	426
Total available-for-sale securities	$ 153,072	$ 2,136	$ 128,783	$ 2,253	$ 281,855	$ 4,389	550

(dollars in thousands)	At December 31, 2018						
	Less than 12 months		12 months or longer		Total		
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses	No. of holdings
Available-for-sale securities:							
U.S. Treasury	$ 129,474	$ 19	$ 11,656	$ 197	$ 141,130	$ 216	7
Corporate debt securities	157,300	6,866	86,586	2,688	243,886	9,554	635
Residential mortgage-backed securities	777	6	1,618	26	2,395	32	3
Commercial mortgage-backed securities	17,624	175	16,997	412	34,621	587	30
Collateralized debt obligations	55,246	826	1,248	4	56,494	830	39
Other debt securities	8,213	11	0	0	8,213	11	7
Total available-for-sale securities	$ 368,634	$ 7,903	$ 118,105	$ 3,327	$ 486,739	$ 11,230	721
Quality breakdown of available-for-sale securities:							
Investment grade	$ 242,821	$ 1,295	$ 98,118	$ 1,641	$ 340,939	$ 2,936	147
Non-investment grade	125,813	6,608	19,987	1,686	145,800	8,294	574
Total available-for-sale securities	$ 368,634	$ 7,903	$ 118,105	$ 3,327	$ 486,739	$ 11,230	721

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

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Net investment income

Investment income, net of expenses, was generated from the following portfolios:

	Three months ended March 31,	
(in thousands)	2019	2018
Fixed maturities [(1)]	$6,161	$6,110
Equity securities	141	142
Cash equivalents and other	2,465	1,008
Total investment income	8,767	7,260
Less: investment expenses	250	440
Investment income, net of expenses	$8,517	$6,820

(1) Includes interest earned on note receivable from Erie Family Life Insurance Company of $0.4 million for the three months ended March 31, 2018. The note was repaid in full in December 2018.

Realized investment gains (losses)

Realized gains (losses) on investments were as follows:

	Three months ended March 31,	
(in thousands)	2019	2018
Available-for-sale securities:		
Gross realized gains	$2,258	$340
Gross realized losses	(340)	(685)
Net realized gains (losses) on available-for-sale securities	1,918	(345)
Equity securities	585	(120)
Net realized investment gains (losses)	$2,503	$(465)

The portion of net unrealized gains and losses recognized during the reporting period, related to equity securities still held at the reporting date, is calculated as follows:

	Three months ended March 31,	
(in thousands)	2019	2018
Equity securities:		
Net gains (losses) recognized during the period	$ 585	$ (120)
Less: net losses recognized on securities sold	0	(34)
Net unrealized gains (losses) recognized on securities held at reporting date	$ 585	$ (86)

Other-than-temporary impairments on available-for-sale securities recognized in earnings were $0.1 million for the three months ended March 31, 2019. There were no other-than-temporary impairments on available-for-sale securities recognized in earnings for the three months ended March 31, 2018. We have the intent to sell all credit-impaired available-for-sale debt securities; therefore, the entire amount of the impairment charges were included in earnings and no non-credit impairments were recognized in other comprehensive income.

Limited partnerships

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 and are generally reported on a one-quarter lag; therefore, our year-to-date limited partnership results through March 31, 2019 are comprised of partnership financial results for the fourth quarter of 2018. Given the lag in reporting, our limited partnership results do not reflect the market conditions of the first quarter of 2019. Cash contributions made to and distributions received from the partnerships are recorded in the period in which the transaction occurs. At December 31, 2018 we also owned one real estate limited partnership that did not meet the criteria of an investment company. This partnership prepared audited financial statements on a cost basis. We elected to report this limited partnership under the fair value option, which was based on the 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. This real estate limited partnership was fully liquidated in January 2019.

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Equity in losses of limited partnerships by method of accounting were as follows:

(in thousands)	Three months ended March 31, 2019	2018
Equity in (losses) earnings of limited partnerships - equity method	$(1,147)	$195
Change in fair value of limited partnerships - fair value option	0	(387)
Equity in losses of limited partnerships	$(1,147)	$(192)

The following table summarizes limited partnership investments by sector:

(in thousands)	At March 31, 2019	At December 31, 2018
Private equity	$26,691	$ 28,271
Mezzanine debt	1,118	1,152
Real estate	2,229	2,192
Real estate - fair value option	0	3,206
Total limited partnership investments	$30,038	$ 34,821

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

Note 7. Leases

Lease assets and liabilities recorded on our Statement of Financial Position were as follows:

(in thousands)	March 31, 2019
Operating lease assets	$ 28,611
Operating lease liabilities - current	$ 12,466
Operating lease liabilities - long-term	16,589
Total operating lease liabilities	$ 29,055

We currently have leases for real estate, technology equipment, copiers, and vehicles. Our largest operating lease asset at March 31, 2019 of $16.2 million is for office space leased from the Exchange, including the home office. Under this lease, rent is based on rental rates of like property and all operating expenses are the responsibility of the tenant (Indemnity). The lease agreement expires December 31, 2021.

Operating lease costs for the three months ended March 31, 2019 were $3.6 million. Of this amount, the Exchange and its subsidiaries reimbursed us $1.5 million, which represents the allocated share of lease costs supporting administrative services activities.

Note 8. Borrowing Arrangements

Bank line of credit

As of March 31, 2019, we have access to a $100 million bank revolving line of credit with a $25 million letter of credit sublimit that expires on October 30, 2023. As of March 31, 2019, a total of $99.1 million remains available under the facility due to $0.9 million outstanding letters of credit, which reduce the availability for letters of credit to $24.1 million. We had no borrowings outstanding on our line of credit as of March 31, 2019. Investments with a fair value of $109.4 million were pledged as collateral on the line at March 31, 2019. The investments pledged as collateral have no trading restrictions and are reported as cash and cash equivalents and available-for-sale securities in the Statements of Financial Position as of March 31, 2019. The banks require compliance with certain covenants, which include leverage ratios and debt restrictions, for our line of credit. We are in compliance with all covenants at March 31, 2019.

Term loan credit facility

In 2016, we entered into a credit agreement for a $100 million senior secured draw term loan credit facility ("Credit Facility") for the acquisition of real property and construction of an office building that will serve as part of our principal headquarters.

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On January 1, 2019, the Credit Facility converted to a fully-amortized term loan with monthly payments of principal and interest at a fixed rate of 4.35% over a period of 28 years. Investments with a fair value of $115.0 million were pledged as collateral for the facility and are reported as cash and cash equivalents and available-for-sale securities in the Statements of Financial Position as of March 31, 2019. The bank requires compliance with certain covenants, which include leverage ratios, debt restrictions and minimum net worth, for our Credit Facility. We are in compliance with all covenants at March 31, 2019.

The remaining unpaid balance from the Credit Facility is reported at carrying value on our Statements of Financial Position, net of unamortized loan origination and commitment fees. See Note 5, "Fair Value" for the estimated fair value of these borrowings.

Annual principal payments

The following table sets forth future principal payments:

(in thousands)

Year	Principal payments
2019	$1,410
2020	1,953
2021	2,040
2022	2,130
2023	2,225
Thereafter	89,782

Note 9. Postretirement Benefits

Pension plans

Our pension plans consist of a noncontributory defined benefit pension plan covering substantially all employees and an unfunded supplemental employee retirement plan 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 and its subsidiaries reimburse us for approximately 59% of the annual benefit expense of these plans, which represents pension benefits for employees performing administrative services and their allocated share of costs for employees in departments that support the administrative functions.

The cost of our pension plans are as follows:

	Three months ended March 31,	
(in thousands)	2019	2018
Service cost for benefits earned	$8,463	$9,513
Interest cost on benefits obligation	9,827	8,846
Expected return on plan assets	(11,871)	(12,815)
Prior service cost amortization	349	338
Net actuarial loss amortization	1,278	3,202
Pension plan cost (1)	$8,046	$9,084

(1) The components of pension plan costs other than the service cost component are included in the line item "Other income" in the Statements of Operations after reimbursements from the Exchange and its subsidiaries.

Note 10. Income Taxes

Income tax expense is provided on an interim basis based upon our estimate of the annual effective income tax rate, adjusted each quarter for discrete items. For the three months ended March 31, 2019 and 2018, our effective tax rate is 21.2% and 21.0%, respectively.

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Note 11. Capital Stock

Class A and B common stock
Holders of Class B shares may, at their option, convert their shares into Class A shares at the rate of 2,400 Class A shares per Class B share. There were no shares of Class B common stock converted into Class A common stock during the three months ended March 31, 2019 and the year ended December 31, 2018. There is no provision for conversion of Class A shares to Class B shares, and Class B shares surrendered for conversion cannot be reissued.

Stock repurchases
In 2011, our Board of Directors approved a continuation of the current stock repurchase program of $150 million, with no time limitation. There were no shares repurchased under this program during the three months ended March 31, 2019 and the year ended December 31, 2018. We had approximately $17.8 million of repurchase authority remaining under this program at March 31, 2019.

During the three months ended March 31, 2019, we purchased 9,725 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of $1.5 million. Of this amount, we purchased 3,246 shares for $0.4 million, or $132.35 per share, for stock-based awards in conjunction with our equity compensation plan, for which the shares were delivered to plan participants in January 2019. We purchased 2,304 shares for $0.4 million, or $183.62 per share, to fund the rabbi trust for the outside director deferred stock compensation plan. The shares were transferred to the rabbi trust in February 2019. The remaining 4,175 shares were purchased at a total cost of $0.7 million, or $175.23 per share, to fund the rabbi trust for the incentive compensation deferral plan. The shares were transferred to the rabbi trust in February and March 2019.

During the year ended December 31, 2018, we purchased 27,120 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of $3.2 million. Of this amount, we purchased 5,830 shares for $0.7 million, or $117.39 per share, for stock-based awards in conjunction with our equity compensation plan. We purchased 9,285 shares for $1.1 million, or $122.19 per share, to fund the rabbi trust for the outside director deferred stock compensation plan. The remaining 12,005 shares were purchased at a total cost of $1.4 million, or $119.28 per share, to fund the rabbi trust for the incentive compensation deferral plan. These shares were delivered in 2018.

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Note 12. Accumulated Other Comprehensive Income (Loss)

Changes in accumulated other comprehensive income ("AOCI") (loss) by component, including amounts reclassified to other comprehensive income ("OCI") (loss) and the related line item in the Statements of Operations where net income is presented, are as follows:

	Three months ended March 31, 2019			Three months ended March 31, 2018		
(in thousands)	Before Tax	Income Tax	Net	Before Tax	Income Tax	Net
Investment securities:						
AOCI (loss), beginning of period	$(9,169)	$(1,926)	$(7,243)	$3,410	$716	$2,694
OCI (loss) before reclassifications	8,774	1,843	6,931	(7,130)	(1,497)	(5,633)
Realized investment (gains) losses	(1,918)	(403)	(1,515)	345	72	273
Impairment losses	78	16	62	0	0	0
Cumulative effect of adopting ASU 2016-01 [(1)]	—	—	—	(85)	(18)	(67)
OCI (loss)	6,934	1,456	5,478	(6,870)	(1,443)	(5,427)
AOCI (loss), end of period	$(2,235)	$(470)	$(1,765)	$(3,460)	$(727)	$(2,733)
Pension and other postretirement plans:						
AOCI (loss), beginning of period	$(155,749)	$(32,708)	$(123,041)	$(200,954)	$(42,201)	$(158,753)
Amortization of prior service costs [(2)]	349	73	276	0	0	0
Amortization of net actuarial loss [(2)]	1,210	254	956	0	0	0
OCI	1,559	327	1,232	0	0	0
AOCI (loss), end of period	$(154,190)	$(32,381)	$(121,809)	$(200,954)	$(42,201)	$(158,753)
Total						
AOCI (loss), beginning of period	$(164,918)	$(34,634)	$(130,284)	$(197,544)	$(41,485)	$(156,059)
Investment securities	6,934	1,456	5,478	(6,870)	(1,443)	(5,427)
Pension and other postretirement plans	1,559	327	1,232	0	0	0
OCI (loss)	8,493	1,783	6,710	(6,870)	(1,443)	(5,427)
AOCI (loss), end of period	$(156,425)	$(32,851)	$(123,574)	$(204,414)	$(42,928)	$(161,486)

(1) ASU 2016-01 required a reclassification of unrealized losses of equity securities from AOCI to retained earnings at January 1, 2018.

(2) Effective January 1, 2019, amounts reclassified from AOCI related to amortization of prior service costs and net actuarial loss were recorded during interim periods. Prior to 2019, amounts reclassified for these items were recorded on an annual basis. These components are included in the computation of net periodic pension cost. See Note 9, "Postretirement Benefits", for additional information.

Note 13. Concentrations of Credit Risk

Financial instruments could potentially expose us to concentrations of credit risk, including unsecured receivables from the Exchange. A large majority of our revenue and receivables are from the Exchange and its subsidiaries. See also Note 1, "Nature of Operations". Management fee amounts and other reimbursements due from the Exchange and its subsidiaries were $456.1 million and $449.9 million at March 31, 2019 and December 31, 2018, respectively.

Note 14. Commitments and Contingencies

We have contractual commitments to invest up to $9.8 million related to our limited partnership investments at March 31, 2019. These commitments are split among private equity securities of $4.4 million and mezzanine debt securities of $5.4 million. These commitments will be funded as required by the limited partnership agreements.

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

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

Note 15. Subsequent Events

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

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

The following discussion of financial condition and results of operations highlights significant factors influencing Erie Indemnity Company ("Indemnity", "we", "us", "our"). This discussion should be read in conjunction with the historical financial statements and the related notes thereto included in Part I, Item 1. "Financial Statements" of this Quarterly Report on Form 10-Q, and with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for the year ended December 31, 2018, as contained in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 21, 2019.

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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;
- 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;
- costs of providing policy issuance and renewal services to the Exchange under the subscriber's agreement;
- credit risk from the Exchange;
- ability to attract and retain talented management and employees;
- ability to ensure system availability and effectively manage technology initiatives;
- difficulties with technology or data security breaches, including cyber attacks;
- ability to maintain uninterrupted business operations;
- factors affecting the quality and liquidity of our investment portfolio;

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- 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.

RECENT ACCOUNTING STANDARDS

See Part I, Item 1. "Financial Statements - Note 2, Significant Accounting Policies, of Notes to Financial Statements" contained within this report for a discussion of recently adopted as well as other recently issued accounting standards and the impact on our financial statements if known.

OPERATING OVERVIEW

Overview

We serve as the attorney-in-fact for the subscribers (policyholders) at the Exchange, a reciprocal insurer that writes property and casualty insurance. Our primary function as attorney-in-fact is to perform policy issuance and renewal services on behalf of the subscribers at the Exchange. We also act as attorney-in-fact on behalf of the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all administrative services.

The Exchange is a reciprocal insurance exchange, which is an unincorporated association of individuals, partnerships and corporations that agree to insure one another. 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 for acting as attorney-in-fact in these two capacities, we earn a management fee calculated as a percentage of the direct and affiliated assumed premiums written by the Exchange.

Our earnings are primarily driven by the management fee revenue generated for the services we provide to the Exchange. The policy issuance and renewal 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 generally comprises approximately two-thirds of our policy issuance and renewal expenses. The underwriting services we provide include underwriting and policy processing. The remaining services we provide include customer service and administrative support. We also provide information technology services that support all the functions listed above. Included in these expenses are allocations of costs for departments that support these policy issuance and renewal functions.

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. Claims handling services include costs incurred in the claims process, including the adjustment, investigation, defense, recording and payment functions. Life insurance management services include costs incurred in the management and processing of life insurance business. Investment management services are related to investment trading activity, accounting and all other functions attributable to the investment of funds.

Included in these expenses are allocations of costs for departments that support these administrative functions. The amounts incurred for these services are reimbursed to Indemnity at cost in accordance with the subscriber's agreement and the service agreements. State insurance regulations require that intercompany service agreements and any material amendments be approved in advance by the state insurance department.

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 affiliated assumed premiums written by the Exchange. The Exchange generates revenue by insuring preferred and standard risks, with personal lines comprising 71% of the 2018 direct and affiliated 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.

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Financial Overview

	Three months ended March 31,		
(dollars in thousands, except per share data)	2019	2018	% Change
	(Unaudited)		
Operating income	$86,122	$77,567	11.0 %
Total investment income	9,795	6,163	58.9
Interest expense, net	449	553	(18.7)
Other income	47	44	7.3
Income before income taxes	95,515	83,221	14.8
Income tax expense	20,204	17,463	15.7
Net income	$75,311	$65,758	14.5 %
Net income per share - diluted	$1.44	$1.26	14.5 %

Operating income increased in the first quarter of 2019, compared to the first quarter of 2018, as the growth in total operating revenue outpaced the growth in total operating expenses. Management fee revenue for policy issuance and renewal services increased $25.0 million to $431.0 million in the first quarter of 2019, compared to the first quarter of 2018. Management fee revenue for administrative services increased $0.9 million to $14.0 million in the first quarter of 2019, compared to the first quarter of 2018. Management fee revenue is based upon the management fee rate we charge, and the direct and affiliated assumed premiums written by the Exchange. The management fee rate was 25% for both 2019 and 2018. The direct and affiliated assumed premiums written by the Exchange increased 6.0% to $1.8 billion in the first quarter of 2019, compared to the the first quarter of 2018. The administrative services reimbursement revenue and corresponding cost of operations increased both total operating revenue and total operating expenses by $142.5 million in the first quarter of 2019 and $146.0 million in the first quarter of 2018, but had no net impact on operating income in either period.

Cost of operations for policy issuance and renewal services increased 4.8% in the first quarter of 2019, compared to the first quarter of 2018, primarily due to higher commissions driven by direct written premium growth and technology investments.

Total investment income increased $3.6 million in the first quarter of 2019, compared to the first quarter of 2018. The increase was driven by net realized gains on investments and higher net investment income, somewhat offset by losses generated from limited partnership investments.

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 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.

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RESULTS OF OPERATIONS

Management fee revenue

We have two performance obligations in the subscriber's agreement, providing policy issuance and renewal services and acting as attorney-in-fact for the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all administrative services. We earn management fees for acting as the attorney-in-fact for the subscribers at the Exchange in these two capacities, and allocate our revenues between our performance obligations.

The management fee is calculated by multiplying all direct and affiliated assumed premiums written by the Exchange by the management fee rate, which is determined by our Board of Directors at least annually. The management fee rate was set at 25%, the maximum rate, for both 2019 and 2018. Changes in the management fee rate can affect our revenue and net income significantly. The transaction price, including management fee revenue and administrative service reimbursement revenue, is allocated based on the estimated standalone selling prices developed using industry information and other available information for similar services. We update the transaction price allocation annually based upon the most recent information available. There was no material change to the allocation in 2019.

The following table presents the allocation and disaggregation of revenue for our two performance obligations:

	Three months ended March 31,		
(dollars in thousands)	2019	2018	% Change
	(Unaudited)		
Policy issuance and renewal services			
Direct and affiliated assumed premiums written by the Exchange	$1,784,520	$1,682,794	6.0 %
Management fee rate	24.2 %	24.2 %	
Management fee revenue	431,854	407,236	6.0
Change in allowance for management fee returned on cancelled policies (1)	(871)	(1,258)	30.8
Management fee revenue - policy issuance and renewal services, net	$430,983	$405,978	6.2 %
Administrative services			
Direct and affiliated assumed premiums written by the Exchange	$1,784,520	$1,682,794	6.0 %
Management fee rate	0.8 %	0.8 %	
Management fee revenue	14,276	13,462	6.0
Change in contract liability (2)	(310)	(374)	17.1
Change in allowance for management fee returned on cancelled policies (1)	(15)	(14)	(5.8)
Management fee revenue - administrative services, net	13,951	13,074	6.7
Administrative services reimbursement revenue	142,480	145,963	(2.4)
Total revenue from administrative services	$156,431	$159,037	(1.6) %

(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. This estimated allowance has been allocated between the two performance obligations consistent with the revenue allocation proportion.

(2) Management fee revenue - administrative services is recognized over time as the services are performed. See Part I, Item 1. "Financial Statements - Note 3, Revenue, of Notes to Financial Statements" contained within this report.

Direct and affiliated assumed premiums written by the Exchange

Direct and affiliated assumed premiums include premiums written directly by the Exchange and premiums assumed from its wholly owned property and casualty subsidiaries. Direct and affiliated assumed premiums written by the

Exchange increased 6.0% to $1.8 billion in the first quarter of 2019, from $1.7 billion in the first quarter of 2018, driven by increases in both policies in force and average premium per policy. Year-over-year policies in force for all lines of business increased 3.1% in the first quarter of 2019 driven by continuing strong policyholder retention, compared to 3.5% in the first quarter of 2018. The year-over-year average premium per policy for all lines of business increased 3.5% at March 31, 2019, compared to 2.6% at March 31, 2018.

Premiums generated from new business decreased 2.5% to $212 million in the first quarter of 2019. While year-over-year average premium per policy on new business increased 6.3% at Mar