ERIE INDEMNITY CO
Form 10-K
February 27, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

**FORM 10-K**

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

For the fiscal year ended December 31, 2011

OR

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

Commission File Number 0-24000

# ERIE INDEMNITY COMPANY

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Pennsylvania<br>(State or other jurisdiction<br>of incorporation or organization) | 25-0466020<br>(I.R.S. Employer<br>Identification No.) |
| 100 Erie Insurance Place, Erie, Pennsylvania<br>(Address of principal executive offices) | 16530<br>(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 _X_ 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 _X_

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

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

Indicate by check mark 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 _X_ | Accelerated Filer ___ | Non-Accelerated Filer ___ (Do not check if a smaller reporting company) | Smaller Reporting Company ___ |

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

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

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

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

**DOCUMENTS INCORPORATED BY REFERENCE**

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

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# PART I

## ITEM 1. BUSINESS

### General

Erie Indemnity Company ( Indemnity ) is a publicly held Pennsylvania business corporation that has been the managing attorney-in-fact for the subscribers (policyholders) at the Erie Insurance Exchange ( Exchange ) since 1925. The Exchange is a subscriber owned, Pennsylvania-domiciled reciprocal insurer that writes property and casualty insurance.

Indemnity s primary function is to perform certain services for the Exchange relating to the sales, underwriting and issuance of policies on behalf of the Exchange. This is done in accordance with a subscriber s agreement (a limited power of attorney) executed by each subscriber (policyholder), which appoints Indemnity as their common attorney-in-fact to transact business on their behalf and to manage the affairs of the Exchange. Pursuant to the subscriber s agreement and for its services as attorney-in-fact, Indemnity earns a management fee calculated as a percentage of the direct premiums written by the Exchange and the other members of the Property and Casualty Group (defined below), which are assumed by the Exchange under an intercompany pooling arrangement.

Indemnity has the power to direct the activities of the Exchange that most significantly impact the Exchange s economic performance by acting as the common attorney-in-fact and decision maker for the subscribers (policyholders) at the Exchange.

Through December 31, 2010, Indemnity also operated as a property and casualty insurer through its wholly owned subsidiaries, Erie Insurance Company ( EIC ), Erie Insurance Company of New York ( ENY ) and Erie Insurance Property and Casualty Company ( EPC ). EIC, ENY and EPC, together with the Exchange and its wholly owned subsidiary, Flagship City Insurance Company ( Flagship ), are collectively referred to as the Property and Casualty Group . The Property and Casualty Group operates in 11 Midwestern, Mid-Atlantic and Southeastern states and the District of Columbia and writes primarily private passenger automobile, homeowners, commercial multi-peril, commercial automobile and workers compensation lines of insurance. On December 31, 2010, Indemnity sold all of the outstanding capital stock of its wholly owned property and casualty insurance subsidiaries to the Exchange.

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

All property and casualty and life insurance operations are owned by the Exchange, and Indemnity functions solely as the management company.

The consolidated financial statements of Erie Indemnity Company reflect the results of Indemnity and its variable interest entity, the Exchange, which we refer to collectively as Erie Insurance Group ( we, us, our ).

Indemnity shareholder interest refers to the interest in Erie Indemnity Company owned by the Class A and Class B shareholders. Noncontrolling interest refers to the interest in the Erie Insurance Exchange held for the subscribers (policyholders).

**Business Segments**

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

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

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

The members of the Property and Casualty Group pool their underwriting results under an intercompany pooling agreement. Under the pooling agreement, the Exchange retains a 94.5% interest in the net underwriting results of the Property and Casualty Group, while EIC retains a 5.0% interest and ENY retains a 0.5% interest. Prior to December 31, 2010, the underwriting results retained by EIC and ENY accrued to the Indemnity shareholder interest. Due to the sale of Indemnity s property and casualty insurance subsidiaries to the Exchange on December 31, 2010, all property and casualty underwriting results accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after December 31, 2010.

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

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

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

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

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

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

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

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

**Competition**

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

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

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

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

EFL, our life insurer, is subject to many of the same structural advantages and environmental challenges as the Property and Casualty Group. Term life business accounts for the majority of policies issued by EFL, and this product line is extremely competitive and increasingly transparent due in part to the proliferation of on-line quoting services. Besides price, ease of application and processing improvements represent areas where companies are finding ways to differentiate themselves among independent producers. EFL continues to progress in these areas using state-of-the-art technology and third-party vendors. Historically, sound underwriting and disciplined approaches to pricing and investing have contributed to favorable operating results. While EFL will be challenged to maintain these trends in the face of intensified competition going forward, we continually shape our strategy and core processes to respond more effectively to the needs of our policyholders and independent agents.

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**Employees**

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

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

Loss reserves are established to account for the estimated ultimate costs of loss and loss expenses for claims that have been reported but not yet settled and claims that have been incurred but not reported. While we exercise professional diligence to establish reserves at the end of each period that are fully reflective of the ultimate value of all claims incurred, these reserves are, by their nature, only estimates and cannot be established with absolute certainty. The factors which may potentially cause the greatest variation between current reserve estimates and the actual future paid amounts are: unforeseen changes in statutory or case law altering the amounts to be paid on existing claim obligations, new medical procedures and/or drugs with costs significantly different from those seen in the past, and claims patterns on current business that differ significantly from historical claims patterns. A discussion of our property and casualty loss reserve methodology can be found in and is referenced to Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates contained within this report.

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

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

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

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

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

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

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

Property and Casualty Group
Reserves for Unpaid Losses and Loss Expenses

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

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

**Government Regulation**

Property and casualty insurers are subject to supervision and regulation in the states in which they transact business. The extent of such regulation varies, but generally derives from state statutes that delegate regulatory, supervisory and administrative authority to state insurance departments. Accordingly, the authority of the state insurance departments includes the establishment of standards of solvency that must be met and maintained by insurers, the licensing to do business of insurers and agents, the nature of the limitations on investments, the approval of premium rates for property and casualty insurance, the provisions that insurers must make for current losses and future liabilities, the deposit of securities for the benefit of policyholders, the approval of policy forms, notice requirements for the cancellation of policies and the approval of certain changes in control. In addition, many states have enacted variations of competitive rate-making laws that allow insurers to set certain premium rates for certain classes of insurance without having to obtain the prior approval of the state insurance department. State insurance departments also conduct periodic examinations of the affairs of insurance companies and require the filing of quarterly and annual reports relating to the financial condition of insurance companies.

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

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

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

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

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

**Website Access**

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

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

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**ITEM 1A. RISK FACTORS**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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- Interest rate risk  the risk of adverse changes in the value of fixed-income securities as a result of increases in market interest rates.

- Investment credit risk  the risk that the value of certain investments may decrease due to the deterioration in financial condition of, or the liquidity available to, one or more issuers of those securities or, in the case of asset-backed securities, due to the deterioration of the loans or other assets that underlie the securities, which, in each case, also includes the risk of permanent loss.

- Concentration risk  the risk that the portfolio may be too heavily concentrated in the securities of one or more issuers, sectors, or industries, which could result in a significant decrease in the value of the portfolio in the event of a deterioration of the financial condition, performance, or outlook of those issuers, sectors, or industries.

- Liquidity risk  the risk that Indemnity will not be able to convert investment securities into cash on favorable terms and on a timely basis, or that Indemnity will not be able to sell them at all, when desired. Disruptions in the financial markets, or a lack of buyers for the specific securities that Indemnity is trying to sell, could prevent it from liquidating securities or cause a reduction in prices to levels that are not acceptable to Indemnity.

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

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

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

Indemnity recognizes management fees due from the Exchange as income when the premiums are written because at that time Indemnity has performed substantially all of the services it is required to perform, including sales, underwriting and policy issuance activities. However, such fees are not paid to Indemnity by the Exchange until the Exchange collects the premiums from policyholders. As a result, Indemnity holds receivables for management fees since such fees are based upon premiums that have been written and assumed. Indemnity also holds receivables from the Exchange for costs it pays on the Exchange s behalf. The receivable from the Exchange totaled $254 million or 21% of our total assets at December 31, 2011.

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

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

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

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

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

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

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

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

Unfavorable changes in economic conditions, including declining consumer confidence, inflation, high unemployment and the threat of recession, among others, may lead the Property and Casualty Group s customers to modify coverage, not renew policies, or even cancel policies, which could adversely affect the premium revenue of the Property and Casualty Group, and consequently Indemnity s management fee. These conditions could also impair the ability of customers to pay premiums when due, and as a result, the Property and Casualty Group s bad debt write-offs could increase.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Interest rate risk the risk of adverse changes in the value of fixed-income securities as a result of increases in market interest rates.

- Investment credit risk the risk that the value of certain investments may decrease due to the deterioration in financial condition of, or the liquidity available to, one or more issuers of those securities or, in the case of asset-backed securities, due to the deterioration of the loans or other assets that underlie the securities, which, in each case, also includes the risk of permanent loss.

- Concentration risk the risk that the portfolio may be too heavily concentrated in the securities of one or more issuers, sectors, or industries, which could result in a significant decrease in the value of the portfolio in the event of a deterioration of the financial condition, performance, or outlook of those issuers, sectors, or industries.

- Liquidity risk the risk that the Exchange will not be able to convert investment securities into cash on favorable terms and on a timely basis, or that the Exchange will not be able to sell them at all, when desired. Disruptions in the financial markets, or a lack of buyers for the specific securities that the Exchange is trying to sell, could prevent it from liquidating securities or cause a reduction in prices to levels that are not acceptable to the Exchange.

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

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

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

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

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

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

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

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

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

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

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

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

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

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**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

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

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

**ITEM 3. LEGAL PROCEEDINGS**

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

**ITEM 4. REMOVED AND RESERVED**

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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**

Indemnity s Class A, non-voting common stock trades on The NASDAQ Stock MarketSM LLC under the symbol ERIE. No established trading market exists for the Class B voting common stock. American Stock Transfer & Trust Company serves as Indemnity s transfer agent and registrar. As of February 17, 2012, there were approximately 841 beneficial shareholders of record for the Class A non-voting common stock and 11 beneficial shareholders of record for the Class B voting common stock.

Historically, Indemnity has declared and paid cash dividends on a quarterly basis at the discretion of its 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, Indemnity s operating results, financial condition, cash requirements and general business conditions at the time such payment is considered.

Indemnity s common stock high and low sales prices and cash dividends declared for each full quarter of the last two years were as follows:

| Indemnity Shareholder Interest | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | | | | 2010 | | | |
| | Sales price | | Cash dividend declared | | Sales price | | Cash dividend declared | |
| Quarter ended | High | Low | Class A | Class B | High | Low | Class A | Class B |
| March 31 | $71.11 | $64.95 | $0.5150 | $ 77.250 | $43.13 | $38.03 | $0.480 | $ 72.00 |
| June 30 | 72.44 | 67.14 | 0.5150 | 77.250 | 46.89 | 42.59 | 0.480 | 72.00 |
| September 30 | 74.73 | 63.02 | 0.5150 | 77.250 | 56.20 | 44.38 | 0.480 | 72.00 |
| December 31 | 80.30 | 69.36 | 0.5525 | 82.875 | 65.47 | 55.41 | 0.515 | 77.25 |
| Total | | | $2.0975 | $314.625 | | | $1.955 | $293.25 |

**Stock Performance**

The following graph depicts the cumulative total shareholder return (assuming reinvestment of dividends) for the periods indicated for Indemnity s Class A common stock compared to the Standard & Poor s 500 Stock Index, the Standard & Poor s Property-Casualty Insurance Index, and the Standard & Poor s Supercomposite Insurance Brokers Sub Industry Index. The comparison to the Standard & Poor s Supercomposite Insurance Brokers Sub Industry Index was added in 2011 due to the sale of Indemnity s property and casualty insurance subsidiaries to the Exchange, which occurred on December 31, 2010. After December 31, 2010, all property and casualty underwriting results accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, and Indemnity functions solely as the management company.

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Erie Indemnity Company Class A common stock | $100(1) | $ 92 | $71 | $77 | $132 | $162 |
| Standard & Poor s 500 Stock Index | 100(1) | 105 | 67 | 84 | 97 | 99 |
| Standard & Poor s Property-Casualty Insurance Index | 100(1) | 87 | 62 | 69 | 75 | 75 |
| Standard & Poor s Supercomposite Insurance Broker Sub Industry Index | 100(1) | 94 | 44 | 49 | 57 | 53 |

*(1) Assumes $100 invested at the close of trading, on the last trading day preceding the first day of the fifth preceding fiscal year, in Indemnity s Class A common stock, the Standard & Poor s 500 Stock Index, the Standard & Poor s Property-Casualty Insurance Index, and the Standard & Poor s Supercomposite Insurance Brokers Sub Industry Index.*

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**Issuer Purchases of Equity Securities**

A stock repurchase program was authorized by our Board of Directors on January 1, 2004, allowing the repurchase of up to $250 million of Indemnity s outstanding Class A nonvoting common stock through December 31, 2006. Our Board of Directors approved continuations of this stock repurchase program for an additional $250 million in February 2006, $100 million in September 2007, and $100 million in April 2008. Subsequent continuations were approved for amounts that included and were not in addition to any unspent amounts under the current program of $100 million in May 2009, $100 million in April 2010, $150 million in December 2010, and most recently for $150 million in October 2011, which was authorized with no time limitation. As of February 17, 2012, we have approximately $128 million of repurchase authority remaining under this program.

Indemnity may purchase shares, from time-to-time, in the open market or through privately negotiated transactions, depending upon prevailing market conditions and alternative uses of capital, and at times and in a manner that is deemed appropriate. During 2011, shares repurchased totaled 2.2 million at a total cost of $155 million. See Item 8. Financial Statements and Supplementary Data Note 18, Capital Stock, of Notes to Consolidated Financial Statements contained within this report for discussion of additional shares repurchased outside of this program.

The following table summarizes Indemnity s Class A common stock repurchased each month, based upon trade date, during the quarter ended December 31, 2011:

*(dollars in millions, except per share data)*

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Approximate Dollar Value of Shares that May Yet be Purchased Under the Program |
|---|---|---|---|---|
| October 1 31, 2011 | 156,465 | $74.55 | 156,465 | $149 |
| November 1 30, 2011 | 75,773 | 74.83 | 75,773 | 143 |
| December 1 31, 2011 | 73,467 | 76.58 | 73,467 | 138 |
| Total | 305,705 | | 305,705 | |

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## ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

| | ERIE INDEMNITY COMPANY | | | | | | |
|---|---|---|---|---|---|---|---|
| *(dollars in millions, except share data)* | Years Ended December 31, | | | | | | |
| | 2011 | 2010 | 2009 | | 2008 | | 2007 |
| **Operating Data:** | | | | | | | |
| Premiums earned | $ 4,214 | $ 3,987 | $ 3,869 | | $ 3,834 | | $ 3,832 |
| Net investment income | 433 | 433 | 433 | | 438 | | 451 |
| Realized (losses) gains on investments | (6) | 307 | 286 | | (1,597) | | (5) |
| Equity in earnings (losses) of limited partnerships | 149 | 128 | (369) | | (58) | | 352 |
| Other income | 34 | 35 | 36 | | 34 | | 31 |
| Total revenues | 4,824 | 4,890 | 4,255 | | 2,651 | | 4,661 |
| Net income (loss) | 268 | 660 | 446 | | (616) | | 919 |
| Less: Net income (loss) attributable to noncontrolling interest in consolidated entity Exchange | 99 | 498 | 338 | | (685) | | 706 |
| Net income attributable to Indemnity | 169 | 162 | 108 | | 69 | | 213 |
| | | | | | | | |
| **Per Share Data Attributable to Indemnity:** | | | | | | | |
| Net income per Class A share diluted | $ 3.08 | $ 2.85 | $ 1.89 | | $ 1.19 | | $ 3.43 |
| Book value per share Class A common and equivalent B shares | 14.48 | 16.24 | 15.74 | | 13.79 | | 17.68 |
| Dividends declared per Class A share | 2.0975 | 1.955 | 1.83 | | 1.77 | | 1.64 |
| Dividends declared per Class B share | 314.625 | 293.25 | 274.50 | | 265.50 | | 246.00 |
| | | | | | | | |
| **Financial Position Data:** | | | | | | | |
| Total assets | $14,348 | $14,344 | $13,287 | | $12,505 | | $14,104 |
| Total equity | 6,293 | 6,334 | 5,725 | (1) | 4,759 | | 6,024 |
| Less: Noncontrolling interest in consolidated entity Exchange | 5,512 | 5,422 | 4,823 | (1) | 3,967 | | 4,973 |
| Total equity attributable to Indemnity | 781 | 912 | 902 | (1) | 792 | (2) | 1,051 |

*(1) On April 1, 2009, we adopted the accounting guidance related to non-credit other-than-temporary impairments for our debt security portfolio. The net impact of the cumulative effect adjustment on April 1, 2009 increased retained earnings and reduced other comprehensive income by $6 million, net of tax, related to the Indemnity shareholder interest and by $95 million, net of tax, related to the Exchange, or noncontrolling interest, resulting in no effect on shareholders equity.*

*(2) On January 1, 2008, we adopted the fair value option for our common stock portfolio. The net impact of the cumulative effect adjustment increased retained earnings and reduced other comprehensive income by $11 million, net of tax, related to the Indemnity shareholder interest resulting in no effect on shareholders equity.*

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

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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 the Erie Insurance Group ( 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 they contain important information helpful in evaluating our financial condition and results of operations.

### INDEX



### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

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

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

Risk factors related to the Erie Indemnity Company (  Indemnity  ) shareholder interest:

- dependence upon Indemnity  s relationship with the Exchange and the management fee under the agreement with the subscribers at the Exchange;
- costs of providing services to the Exchange under the subscriber  s agreement;
- ability to attract and retain talented management and employees;
- ability to maintain uninterrupted business operations, including information technology systems;
- factors affecting the quality and liquidity of Indemnity  s investment portfolio;
- credit risk from the Exchange;
- Indemnity  s ability to meet liquidity needs and access capital; and
- outcome of pending and potential litigation against Indemnity.

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Risk factors related to the non-controlling interest owned by the Erie Insurance Exchange ( Exchange ), which includes the Property and Casualty Group and EFL:

- general business and economic conditions;
- dependence upon the independent agency system;
- ability to maintain our reputation for customer service;
- factors affecting insurance industry competition;
- changes in government regulation of the insurance industry;
- premium rates and reserves must be established from forecasts of ultimate costs;
- emerging claims, coverage issues in the industry, and changes in reserve estimates related to the property and casualty business;
- changes in reserve estimates related to the life business;
- severe weather conditions or other catastrophic losses, including terrorism;
- the Exchange s ability to acquire reinsurance coverage and collectability from reinsurers;
- factors affecting the quality and liquidity of the Exchange s investment portfolio;
- the Exchange s ability to meet liquidity needs and access capital;
- the Exchange s ability to maintain an acceptable financial strength rating;
- outcome of pending and potential litigation against the Exchange; and
- dependency upon the service provided by Indemnity.

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

**RECENT ACCOUNTING PRONOUNCEMENTS**

See Item 8. Financial Statements and Supplementary Data - Note 2, Significant Accounting Policies, of Notes to Consolidated Financial Statements contained within this report for a discussion of recently issued accounting pronouncements, none of which are expected to have a material impact on our future financial condition, results of operations or cash flows.

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**OPERATING OVERVIEW**

**Overview**

The Erie Insurance Group represents the consolidated results of Indemnity and the results of its variable interest entity, the Exchange. The Erie Insurance Group operates predominantly as a property and casualty insurer through its regional insurance carriers that write a broad range of personal and commercial coverages. Our property and casualty insurance companies include the Exchange and its wholly owned subsidiaries, Erie Insurance Company ( EIC ), Erie Insurance Company of New York ( ENY ), Erie Insurance Property and Casualty Company ( EPC ) and Flagship City Insurance Company ( Flagship(1)). These entities operate collectively as the Property and Casualty Group. The Erie Insurance Group also operates as a life insurer through the Exchange s wholly owned subsidiary, Erie Family Life Insurance Company ( EFL ), which underwrites and sells individual and group life insurance policies and fixed annuities (2).

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 and for its services as attorney-in-fact, Indemnity earns a management fee calculated as a percentage of the direct premiums written by the Exchange and the other members of the Property and Casualty Group, which are assumed by the Exchange under an intercompany pooling arrangement.

The Indemnity shareholder interest includes Indemnity s equity and income, but not the equity or income of the Exchange.The Exchange s equity, which is comprised of its retained earnings and accumulated other comprehensive income, is held for the interest of its subscribers (policyholders) and meets the definition of a noncontrolling interest, which is reflected as such in our consolidated financial statements.

Indemnity shareholder interest refers to the interest in Erie Indemnity Company owned by the Class A and Class B shareholders. Noncontrolling interest refers to the interest in the Erie Insurance Exchange held for the interest of the subscribers (policyholders).

Indemnity shareholder interest in income generally comprises:

- a management fee of up to 25% of all property and casualty insurance premiums written or assumed by the Exchange, less the costs associated with the sales, underwriting and issuance of these policies;
- a 0% interest in the net underwriting results of the property and casualty insurance operations after December 31, 2010 (the interest was 5.5% prior to December 31, 2010) (1);
- a 0% equity interest in the net earnings of EFL after March 31, 2011 ( the interest was 21.6% prior to March 31, 2011) (2);

- net investment income and results on investments that belong to Indemnity (1); and
- other income and expenses, including income taxes, that are the responsibility of Indemnity.

The Exchange s or the noncontrolling interest in income generally comprises:

- a 100% interest in the net underwriting results of the property and casualty insurance operations after December 31, 2010 (the interest was 94.5% prior to December 31, 2010) (1);
- a 100% equity interest in the net earnings of EFL after March 31, 2011 (the interest was 78.4% prior to March 31, 2011) (2);
- net investment income and results on investments that belong to the Exchange and its subsidiaries, including EFL (1); and
- other income and expenses, including income taxes, that are the responsibility of the Exchange and its subsidiaries.

*(1) Prior to and through December 31, 2010, the underwriting results retained by EIC and ENY and the investment results of EIC, ENY and EPC accrued to the Indemnity shareholder interest. Due to the sale of Indemnity s property and casualty insurance subsidiaries to the Exchange on December 31, 2010, all property and casualty underwriting results and all investment results for these companies accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after December 31, 2010.*

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

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**Results of the Erie Insurance Group s Operations by Interest**

The following table represents a breakdown of the composition of the income attributable to Indemnity and the income attributable to the noncontrolling interest (Exchange). For purposes of this discussion, EFL s investments are included in the life insurance operations(1).

| | | Indemnity shareholder interest Years ended December 31, | | | | Noncontrolling interest (Exchange) Years ended December 31, | | | Eliminations of related party transactions Years ended December 31, | | | Erie Insurance Group Years ended December 31, | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *(in millions)* | Percent | 2011 | 2010 | 2009 | Percent | 2011 | 2010 | 2009 | 2011 | 2010 | 2009 | 2011 | 2010 | 2009 |
| **Management operations:** | | | | | | | | | | | | | | |
| Management fee revenue, net | 100.0% | $1,067 | $1,009 | $ 965 | | $ | $ | $ | $(1,067) | $(1,009) | $(965) | $ | $ | $ |
| Service agreement revenue | 100.0% | 33 | 34 | 35 | | | | | | | | 33 | 34 | 35 |
| Total revenue from management operations | | 1,100 | 1,043 | 1,000 | | | | | (1,067) | (1,009) | (965) | 33 | 34 | 35 |
| Cost of management operations | 100.0% | 892 | 841 | 813 | | | | | (892) | (841) | (813) | | | |
| ***Income from management operations before taxes*** | | 208 | 202 | 187 | | | | | (175) | (168) | (152) | 33 | 34 | 35 |
| **Property and casualty insurance operations:** (2) | | | | | | | | | | | | | | |
| Net premiums earned | 5.5%(2) | | 216 | 209 | 94.5%(2) | 4,149 | 3,709 | 3,599 | | | | 4,149 | 3,925 | 3,808 |
| Losses and loss expenses | 5.5%(2) | | 155 | 145 | 94.5%(2) | 3,349 | 2,660 | 2,499 | (5) | (5) | (5) | 3,344 | 2,810 | 2,639 |
| Policy acquisition and underwriting expenses | 5.5%(2) | | 61 | 63 | 94.5%(2) | 1,178 | 1,052 | 1,072 | (183) | (174) | (158) | 995 | 939 | 977 |
| ***Income (loss) from property and casualty insurance operations before taxes*** | | | 0 | 1 | | (378) | (3) | 28 | 188 | 179 | 163 | (190) | 176 | 192 |
| **Life insurance operations:** (1) | | | | | | | | | | | | | | |
| Total revenue | 21.6%(3) | 10 | 37 | 27 | 78.4%(3) | 167 | 135 | 100 | (2) | (2) | (2) | 175 | 170 | 125 |
| Total benefits and expenses | 21.6%(3) | 7 | 26 | 25 | 78.4%(3) | 120 | 96 | 92 | 0 | (2) | (2) | 127 | 120 | 115 |
| ***Income from life insurance operations before taxes*** | | 3 | 11 | 2 | | 47 | 39 | 8 | (2) | 0 | 0 | 48 | 50 | 10 |
| **Investment operations:** | | | | | | | | | | | | | | |
| Net investment income (2) | | 16 | 37 | 42 | | 335 | 312 | 311 | (11) | (11) | (11) | 340 | 338 | 342 |
| Net realized gains (losses) on Investments (2) | | 3 | (1) | 10 | | (20) | 301 | 397 | | | | (17) | 300 | 407 |
| Net impairment losses recognized in earnings (2) | | 0 | (1) | (12) | | (1) | (3) | (91) | | | | (1) | (4) | (103) |
| Equity in earnings (losses) of limited partnerships | | 26 | 21 | (76) | | 119 | 106 | (283) | | | | 145 | 127 | (359) |
| Goodwill Impairment | | | | | | | (22) | | | | | | (22) | |
| ***Income (loss) from investment operations*** | | 45 | 56 | (36) | | 433 | 694 | 334 | (11) | (11) | (11) | 467 | 739 | 287 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***before taxes*** (2) | | | | | | | | | | | | |
| **Income from operations before income taxes and noncontrolling interest** | 256 | 269 | 154 | 102 | 730 | 370 | | | | 358 | 999 | 524 |
| Provision for income taxes | 87 | 107 | 46 | 3 | 232 | 32 | | | | 90 | 339 | 78 |
| **Net income** | $ 169 | $ 162 | $ 108 | $ 99 | $ 498 | $ 338 | $ | $ | $ | $ 268 | $ 660 | $ 446 |

*(1) Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes, the life insurance operations in the table above include life insurance related investment results. However, the life insurance investment results are included in the investment operations segment discussion as part of the Exchange s investment results.*

*(2) Prior to and through December 31, 2010, the underwriting results retained by EIC and ENY and the investment results of EIC, ENY and EPC accrued to the Indemnity shareholder interest. Due to the sale of Indemnity s property and casualty insurance subsidiaries to the Exchange on December 31, 2010, all property and casualty underwriting results and all investment results for these companies accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after December 31, 2010.*

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

Net income in 2011 was impacted by adverse results in our property and casualty insurance operations compared to 2010 and 2009, and a decline in income from our investment operations compared to 2010. The Exchange s property and casualty insurance operation s losses were higher due to a significant increase in catastrophe losses. This was offset somewhat by favorable development on prior accident years and a 5.7% increase in earned premium, driven by increases in policies in force and the average premium per policy, which also positively impacted Indemnity s management fee revenue. Our investment operations were impacted primarily by net realized losses on investments, compared to gains in 2010 and 2009, offset somewhat by increased equity in earnings on limited partnerships in 2011 and 2010, compared to losses in 2009. In 2010, our noncontrolling interest incurred a charge of $22 million for the impairment of goodwill relating to its purchase of EFL stock in 2006, and the Indemnity shareholder interest incurred a charge of $18 million for a deferred tax expense related to the sale of its 21.6% ownership interest of EFL to the Exchange, which occurred on March 31, 2011.

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**Reconciliation of Operating Income to Net Income**

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

Indemnity defines operating income as income generated from management operations, life insurance operations (1), property and casualty insurance underwriting operations (2), net investment income (2), and equity in earnings or losses of limited partnerships, net of related federal income taxes. It does not include realized capital gains and losses, impairment losses and related federal income taxes.

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

The following table reconciles operating income and net income for the Indemnity shareholder interest for the years ended December 31 (1) (2):

| *(in millions, except per share data)* | Indemnity Shareholder Interest | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Operating income attributable to Indemnity | $ 167 | $ 163 | $ 109 |
| Net realized gains (losses) and impairments on investments | 3 | (2) | (2) |
| Income tax (expense) benefit | (1) | 1 | 1 |
| Realized gains (losses) and impairments, net of income taxes | 2 | (1) | (1) |
| Net income attributable to Indemnity | $ 169 | $ 162 | $ 108 |
| | | | |
| Per Indemnity Class A common share-diluted: | | | |
| Operating income attributable to Indemnity | $3.04 | $2.88 | $1.91 |
| Net realized gains (losses) and impairments on investments | 0.06 | (0.04) | (0.03) |
| Income tax (expense) benefit | (0.02) | 0.01 | 0.01 |
| Realized gains (losses) and impairments, net of income taxes | 0.04 | (0.03) | (0.02) |
| Net income attributable to Indemnity | $3.08 | $2.85 | $1.89 |

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

*(2) Prior to and through December 31, 2010, the underwriting results retained by EIC and ENY and the investment results of EIC, ENY and EPC accrued to the Indemnity shareholder interest. Due to the sale of Indemnity s property and casualty insurance subsidiaries to the Exchange on December 31, 2010, all property and casualty underwriting results and all investment results for these companies accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after December 31, 2010.*

**Summary of Results   Indemnity Shareholder Interest**

Net income attributable to Indemnity per share-diluted was $3.08 per share in 2011, compared to $2.85 per share in 2010, and $1.89 per share in 2009. The net income for 2011, 2010 and 2009 includes $0.02, $0.47 and $0.39 per share, respectively, related to operations sold to the Exchange.

Operating income attributable to Indemnity per share-diluted (excluding net realized gains or losses, impairments on investments and related taxes) was $3.04 per share in 2011, compared to $2.88 in 2010, and $1.91 in 2009. The 2011, 2010 and 2009 operating income amounts include $0.02, $0.42 and $0.46 per share, respectively, related to operations sold to the Exchange.

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**Operating Segments**

Our reportable segments include management operations, property and casualty insurance operations, life insurance operations and investment operations.

Management operations

Management operations generate internal management fee revenue, which accrues to the Indemnity shareholder interest, as Indemnity provides services relating to the sales, underwriting and issuance of policies on behalf of the Exchange. Management fee revenue is based upon all premiums written or assumed by the Exchange and the management fee rate, which is not to exceed 25%. Our Board of Directors establishes the management fee rate at least annually, generally in December for the following year, and considers factors such as the relative financial strength of Indemnity and the Exchange and projected revenue streams. The management fee rate was set at 25% for 2011, 2010 and 2009. Our Board of Directors set the 2012 management fee rate again at 25%, its maximum level. Management fee revenue is eliminated upon consolidation.

Property and casualty insurance operations

The property and casualty insurance business is driven by premium growth, the combined ratio and investment returns. The property and casualty insurance industry is cyclical, with periods of rising premium rates and shortages of underwriting capacity followed by periods of substantial price competition and excess capacity. The cyclical nature of the insurance industry has a direct impact on the direct written premiums of the Property and Casualty Group.

The property and casualty operation s premium growth strategy focuses on growth by expansion of existing operations including a careful agency selection process and increased market penetration in existing operating territories. Expanding the size of our existing agency force of over 2,100 independent agencies, with nearly 9,500 licensed property and casualty representatives, will contribute to future growth as new agents build their books of business with the Property and Casualty Group.

The property and casualty insurance operations insure preferred and standard risks while maintaining a disciplined underwriting approach. The Property and Casualty Group s principal personal lines products based upon 2011 direct written premiums were private passenger automobile (47%) and homeowners (22%), and the principal commercial lines products were commercial multi-peril (12%), commercial automobile (7%) and workers compensation (7%). Pennsylvania, Maryland and Virginia made up 63% of the property and casualty lines insurance business direct written premium in 2011.

Members of the Property and Casualty Group pool their underwriting results under an intercompany pooling agreement. Under the pooling agreement, the Exchange retains a 94.5% interest in the net underwriting results of the Property and Casualty Group, while EIC retains a 5.0% interest and ENY retains a 0.5% interest. Prior to and through December 31, 2010, the underwriting results retained by EIC and ENY accrued to the Indemnity shareholder interest. Due to the sale of Indemnity s property and casualty insurance subsidiaries to the Exchange on December 31, 2010, all property and casualty underwriting results accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after December 31, 2010.

The combined ratio, expressed as a percentage, is the key measure of underwriting profitability traditionally used in the property and casualty insurance industry. It is the sum of the ratio of losses and loss expenses to premiums earned (loss ratio) plus the ratio of policy acquisition and other underwriting expenses to premiums earned (expense ratio). When the combined ratio is less than 100%, underwriting results are generally considered profitable; when the combined ratio is greater than 100%, underwriting results are generally considered unprofitable.

Factors affecting loss and loss expenses include the frequency and severity of losses, the nature and severity of catastrophic losses, the quality of risks underwritten and underlying claims and settlement expenses.

Investments held by the Property and Casualty Group are reported in the investment operations segment, separate from the underwriting business.

Life insurance operations

EFL generates revenues through the sale of its individual and group life insurance policies and fixed annuities. These products provide our property and casualty agency force an opportunity to cross-sell both personal and commercial accounts. EFL s profitability depends principally on the ability to develop, price and distribute insurance products, attract and retain deposit funds, generate investment returns and manage expenses. Other drivers include mortality

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and morbidity experience, persistency experience to enable the recovery of acquisition costs, maintenance of interest spreads over the amounts credited to deposit funds and the maintenance of strong ratings from rating agencies.

Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes in the Management s Discussion and Analysis, the life insurance operations include life insurance related investment results. However, for presentation purposes, in the segment footnote the life insurance investment results are included in the investment operations segment discussion as part of the Exchange s investment results.

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

Investment operations

We generate revenues from our fixed maturity, equity security and limited partnership investment portfolios to support our underwriting business. The portfolios are managed with the objective of maximizing after-tax returns on a risk-adjusted basis. Management actively evaluates the portfolios for impairments. We record impairment writedowns on investments in instances where the fair value of the investment is substantially below cost, and we conclude that the decline in fair value is other-than-temporary.

Our investment operations produced positive results despite periods of volatility in the financial markets during 2011. Net investment income of $433 million in 2011 was unchanged from 2010. During 2011, we incurred $2 million of impairment charges compared to $6 million in 2010. Net realized losses were $4 million in 2011, compared to net gains of $313 million in 2010, primarily reflecting the significant valuation gains on our common stock portfolio in 2010. Equity in earnings of limited partnerships was $149 million in 2011, compared to $128 million in 2010, as market conditions for these investments have generally remained favorable. The results from our limited partnerships are based upon financial statements received from our general partners, which are generally received on a quarter lag. As a result, our 2011 partnerships earnings do not reflect the market conditions experienced in the fourth quarter of 2011.

**General Conditions and Trends Affecting Our Business**

Economic conditions

Unfavorable changes in economic conditions, including declining consumer confidence, inflation, high unemployment and the threat of recession, among others, may lead the Property and Casualty Group s customers to modify coverage, not renew policies, or even cancel policies, which could adversely affect the premium revenue of the Property and Casualty Group, and consequently Indemnity s management fee. These conditions could also impair the ability of customers to pay premiums when due, and as a result, the Property and Casualty Group s bad debt write-offs could increase. Our key challenge is to generate profitable revenue growth in a highly competitive market that continues to experience the effects of uncertain economic conditions.

Financial market volatility

Our portfolio of fixed income, preferred and common stocks and limited partnerships are subject to market volatility especially in periods of instability in the worldwide financial markets. Depending upon market conditions, which are unpredictable and remain uncertain, considerable fluctuation could occur in our reported total investment income, which could have an adverse impact on our financial condition, results of operations and cash flows.

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**CRITICAL ACCOUNTING ESTIMATES**

The consolidated 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.  Management considers 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 Consolidated 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.

**Property and Casualty Insurance Loss and Loss Expense Reserves**

Property and casualty insurance loss and loss expense reserves are established to provide for the estimated costs of paying claims under insurance policies written by us.  These reserves include estimates for both claims that have been reported (case) and those that have been incurred but not reported (IBNR) and include estimates of all future payments associated with processing and settling these claims.

The process of establishing loss reserves is complex and involves a variety of actuarial techniques.  The loss reserve estimation process is based largely on the assumption that past development trends are an appropriate indicator of future events.  Reserve estimates are based upon our assessment of known facts and circumstances, review of historical settlement patterns, estimates of trends in claims frequency and severity, legal theories of liability and other factors.  Variables in the reserve estimation process can be affected by 1) internal factors, including changes in claims handling procedures and changes in the quality of risk selection in the underwriting process, and 2) external events, such as economic inflation and regulatory and legislative changes.  Due to the inherent complexity of the assumptions used, final loss settlements may vary significantly from the current estimates, particularly when those settlements may not occur until well into the future.

How reserves are established

Case reserves are established by a claims handler on each individual claim and are adjusted as new information becomes known during the course of handling the claims.  IBNR reserves represent the difference between the case reserves for actual reported loss and loss expenses and the estimated ultimate cost of all claims.

Our loss and loss expense reserves include amounts related to short-tail and long-tail lines of business.  Tail refers to the time period between the occurrence of a loss and the final settlement of the claim.  The longer the time span between the incidence of a loss and the settlement of the claim, the more the ultimate settlement amount can vary.  Most of our loss and loss expense reserves relate to long-tail liability lines of business including workers compensation, bodily injury and other liability coverages, such as commercial liability.  Short-tail lines of business, which represent a smaller percentage of our loss reserves, include personal auto physical damage and personal property.

Our actuaries review all direct reserve estimates on a quarterly basis for both current and prior accident years using the most current claim data. Reserves for massive injury lifetime medical claims, including auto no-fault and workers compensation claims, are reviewed at a more detailed level semi-annually. These massive injury claim reserves are relatively few in number and are very long-tail liabilities. In intervening quarters, development on massive injury reserves is monitored to confirm that the estimate of ultimate losses should not change. If an unusual development is observed, a detailed review is conducted to determine whether the reserve estimate should change. Significant changes to the factors discussed above, which are either known or reasonably projected through analysis of internal and external data, are quantified in the reserve estimates each quarter.

The quarterly reserve reviews incorporate a variety of actuarial methods and judgments and involve rigorous analysis. A comprehensive review is performed of the various estimation methods and reserve levels produced by each. The various methods generate different estimates of ultimate losses by product line and product coverage combination. Thus, reserves are comprised of a set of point estimates of the ultimate losses developed from the various methods. These multiple reserve point estimates are reviewed by our reserving actuaries and reserve best estimates are selected. The selected reserve estimates are discussed with management.

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Numerous factors are considered in setting reserve levels, including, but not limited to, the assessed reliability of key loss trends and assumptions that may significantly influence the current actuarial indications, the maturity of the accident year, pertinent claims frequency and severity trends observed over recent years, the level of volatility within a particular line of business and the improvement or deterioration of actuarial rate indications in the current period as compared to prior periods. Certain methods are considered more credible for each product/coverage combination depending on the maturity of the accident quarter, the mix of business and the particular internal and external influences impacting the claims experience or the method.

The following is a discussion of the most common methods used:

*Paid development* Paid loss development patterns are generated from historical data organized by accident quarter and calendar quarter and applied to current paid losses by accident quarter to generate estimated ultimate losses. Paid development techniques do not use information about case reserves and therefore are not affected by changes in case reserving practices. These techniques are generally most useful for short-tailed lines since a high percentage of ultimate losses are paid in early periods of development.

*Incurred development* Incurred loss development patterns (reflecting cumulative paid losses plus current case reserves) are generated from historical data organized by accident quarter and calendar quarter. The patterns are applied to current incurred losses by accident quarter to generated estimated ultimate losses. Incurred methods and/or combinations of the paid and incurred methods are used in developing estimated ultimate losses for short-tail coverages, such as personal auto physical damage and personal property claims, and more mature accident quarters of long-tail coverages, such as personal auto liability claims and commercial liability claims, including workers compensation.

*Weather event paid and reported development* The historical patterns utilized in paid and reported development methods for weather events are derived from historical data for the same type of weather event. Initial weather event ultimate loss estimates are reviewed with claims management.

*Bornhuetter-Ferguson* Bornhuetter-Ferguson is a method of combining the expected-loss-ratio ultimate losses and the paid-or-incurred development ultimate losses. It places more weight on the paid-or-incurred development ultimate losses as an accident quarter matures. The Bornhuetter-Ferguson method is generally used on the first four to eight accident quarters on long-tail coverages because a low percentage of losses are paid in the early period of development. An expected loss ratio is developed through a review of historical loss ratios by accident quarter, adjusted for changes to earned premium, mix of business and other factors that are expected to impact the loss ratio for the accident quarter being evaluated. A preliminary estimate of ultimate losses is calculated by multiplying this expected loss ratio by earned premium.

*Survival ratio* This method measures the ratio of the average loss and loss expense amount paid annually to the total reserve for the product line or product coverage. The survival ratio represents the number of years of payments that the current level of reserves will cover. The reserve is established so that a particular ratio, representing the time to closing of all claims, is achieved. This method is also used as a reasonability check of reserve adequacy.

*Individual claim* This method estimates the ultimate losses on a claim-by-claim basis. An annual payment assumption is made for each claimant and then projected into the future based upon a particular assumption of the future inflation rate and life expectancy of the claimant. This method is used for unusual, large claims.

Line of business methods

For each product line and product/coverage combination, certain methods are given more influence than other methods. The discussion below gives a general indication of which methods are preferred for each line of business. As circumstances change, the methods that are given greater weight can change.

*Massive injury lifetime medical claims (such as certain auto no-fault and workers compensation claims)* These claims develop over a long period of time and are relatively few in number. We utilize the individual claim method to evaluate each claim s ultimate losses.

*Personal auto physical damage and homeowners* These lines are fast-developing, and paid and incurred development techniques are used. We rely primarily on incurred development techniques for the most recent accident months.

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*Personal auto liability* (*such as bodily injury and uninsured/underinsured motorist*) For auto liability, and bodily injury in particular, we review the results of a greater number of techniques than for physical damage. We use the Bornhuetter-Ferguson method for the first four to eight accident quarters and paid and incurred development methods for the older accident periods.

*Workers compensation and long-tailed liability (such as commercial liability)* We generally rely upon the expected loss ratio, Bornhuetter-Ferguson and incurred development techniques. These techniques are generally weighted together, relying more heavily on the Bornhuetter-Ferguson method at early ages of development and more on the incurred development method as the accident periods mature.

The methods used for estimating loss expenses are as follows:

*Defense and cost containment expenses (D&CC)* D&CC is analyzed using paid development techniques and an analysis of the relationship between D&CC payments and loss payments.

*Adjusting and other expenses (A&O)* A&O reserves are projected based upon an expected cost per claim year, the anticipated claim closure pattern, and the ratio of paid A&O to paid loss.

Key assumptions for loss reserving

The accuracy of the various methods used to estimate reserves is a function of the degree to which underlying assumptions are satisfied. The most significant key assumptions are:

*Development patterns* Historical paid and incurred amounts contain patterns which indicate how unpaid and IBNR amounts will emerge in future periods. Unless reasons or factors are identified that invalidate the extension of historical patterns into the future, these patterns can be used to make projections necessary for estimating loss and loss adjustment expense reserves. This is the most significant assumption and it applies to all methods.

*Impact of inflation* Property and casualty insurance reserves are established before the extent to which inflation may impact such reserves is known. Consequently, in establishing reserves, we attempt to anticipate the potential impact of inflation, including medical cost inflation, construction and auto repair cost inflation and tort issues. Medical costs are a broad element of inflation that impacts personal and commercial auto, general liability, workers compensation and commercial multi-peril lines of insurance written by the Property and Casualty Group. Inflation assumptions take the form of explicit numerical values in the survival ratio, individual claim, and massive injury lifetime medical reserving methods. Inflation assumptions are implicitly derived through the selection of applicable loss development patterns for all other reserving methods. Occasionally, unusual aberrations in loss development patterns are caused by external and internal factors such as changes in claim reporting and/or settlement patterns, unusually large losses, process changes, legal or regulatory changes, and other influences. In these instances, analyses of alternate development factor selections are performed to evaluate the effect of these factors and actuarial judgment is applied to make appropriate assumptions needed to develop a best estimate of ultimate losses.

*Claims with atypical emergence patterns* Characteristics of certain subsets of claims, such as those with high severity, have the potential to distort patterns contained in historical paid loss and reported loss data. When testing indicates this to be the case for a particular subset of claims, our actuaries segregate these claims from the data and analyze them separately.

*Future cost increases and claimant mortality* Future cost increase assumptions are derived from a review of historical cost increases and are assumed to persist into the future. Future medical cost increases and claimant mortality assumptions utilized in the reserve estimates for massive injury lifetime medical claims are obtained from industry studies adjusted for our own experience. Reserve levels are sensitive to these assumptions because they represent projections over 30 to 40 years into the future.

*Changes in loss ratio trends* Prior loss ratio assumptions utilized in the Bornhuetter-Ferguson method are derived from projections of historical loss ratios based upon actual experience from more mature accident periods adjusted for assumed changes in average premiums, frequency and severity. These assumptions influence only the most recent accident periods, but the majority of reserves originate with the most recent accident periods. Reserve levels are highly sensitive to these assumptions.

*Relationship of loss expense to losses* D&CC-to-loss ratio assumptions utilized in the Bornhuetter-Ferguson method are initially derived from historical relationships. These historical ratios are adjusted according to the impact of changing internal and external factors. The A&O-to-loss ratio assumption is similarly derived from historical relationships and adjusted as required for identified internal or external changes.

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Reserve estimate variability

The property and casualty reserves with the greatest potential for variation are the massive injury lifetime medical reserves. The automobile no-fault law in Pennsylvania before 1986 and workers compensation policies provide for unlimited medical benefits. The estimate of ultimate liabilities for these claims is subject to significant judgment due to variations in claimant health, mortality over time and health care cost trends. Workers compensation massive injury claims have been segregated from the total population of claims. Ultimate losses for these claims are estimated on a claim-by-claim basis. An annual payment assumption is made for each of the claimants who have sustained massive injuries. We are currently reserving for about 285 claimants requiring lifetime medical care, of which 110 involve massive injuries. The annual payment is projected into the future based upon particular assumptions of the future inflation rate and life expectancy of the claimant. The most significant variable in estimating this liability is medical cost inflation. The life expectancy (mortality rate) assumption underlying the estimate reflects experience to date. Actual experience, however, may emerge in a manner that is different relative to the original assumptions, which could have a significant impact on our reserve estimates.

Loss reserves are set at full expected cost, except for workers compensation loss reserves, which are discounted on a nontabular basis using an interest rate of 2.5% and our historical workers compensation payout patterns. In 2009, we changed our workers compensation discounting method to segregate the workers compensation massive injury claims that have longer payout patterns from the non-massive injury workers compensation claims, and continue to use this methodology in 2011.

*Auto no-fault (massive injury lifetime medical claims)* The automobile massive injury reserve carried by the Property and Casualty Group totaled $356 million at December 31, 2011, compared to $440 million at December 31, 2010. The decrease in the pre-1986 automobile massive injury reserves in 2011, compared to 2010, was primarily due to improved annual claims cost expectations and the closing of four massive injury lifetime medical claims. A 100-basis point increase in the medical cost inflation assumption would result in an increase in the Property and Casualty Group s liability of $61 million.

*Workers compensation (massive injury lifetime medical claims)* The workers compensation massive injury reserve carried by the Property and Casualty Group totaled $99 million at December 31, 2011, compared to $154 million at December 31, 2010. The decrease in the workers compensation massive injury reserves in 2011, compared to 2010, was primarily due to the closing of seven massive injury lifetime medical claims. The discount on these reserves was $37 million at December 31, 2011. A 100-basis point increase in the medical cost inflation assumption would result in an increase in the Property and Casualty Group s liability of $26 million and an increase in the discount of $19 million at December 31, 2011.

Workers compensation reserves, excluding massive injury lifetime medical claims, are also subject to discounting. The discount on these reserves was $46 million at December 31, 2011. A 100-basis point increase in the discount rate would decrease these reserves by $16 million.

We also perform analyses to evaluate the adequacy of past total reserve levels for the Property and Casualty Group. Using subsequent information, we perform retrospective reserve analyses to test whether previously established estimates for reserves were reasonable. Our 2011 retrospective reserve analysis for the loss reserve balance at December 31, 2010 indicated that direct reserves, including salvage and subrogation recoveries, were over-estimated by approximately $276 million, or 7.7% of the reserve estimate at December 31, 2010. In 2010, our retrospective reserve analysis indicated that direct reserves, including salvage and subrogation recoveries, were over-estimated by approximately $188 million, or 5.2% of the reserve estimate at December 31, 2009; and in 2009, our retrospective reserve analysis indicated that direct reserves, including salvage and subrogation recoveries, were over-estimated by approximately $30 million, or 0.8% of the reserve estimate at December 31, 2008. See an additional discussion of our reserve development in the Prior year loss reserve development section.

Due to the sale of Indemnity s property and casualty insurance subsidiaries to the Exchange on December 31, 2010, all property and casualty loss and loss expense reserves accrue to the interest of the subscribers (policyholders) of the Exchange, or noncontrolling interest, after December 31, 2010.

**Life Insurance and Annuity Policy Reserves**

Reserves for traditional life insurance future policy benefits are computed primarily by the net level premium method. Generally, benefits are payable over an extended period of time and related reserves are calculated as the present value of future expected benefits to be paid reduced by the present value of future expected net premiums. Such reserves are established based upon methods and underlying assumptions in accordance with generally accepted accounting principles and applicable actuarial standards. Principal assumptions used in the establishment of policy reserves are mortality, lapses, expenses and investment yields.  Mortality assumptions are based upon tables typically used in the industry, modified to reflect actual experience and to include a provision for the risk of adverse deviation where appropriate.  Lapse, expense and investment yield assumptions are based upon actual company experience and may include a provision for the risk of adverse deviation.  Assumptions on these policies are locked in at the time of issue and are not subject to change unless a premium deficiency exists.  A premium deficiency exists if, based upon revised assumptions, the existing contract liabilities together with the present value of future gross premiums are not sufficient to cover the present value of future expected benefits and maintenance costs and to recover unamortized acquisition costs.  Historically, our reserves plus expected gross premiums have been demonstrated to be sufficient.  There were no premium deficiencies in 2011, 2010 or 2009.

Reserves for income-paying annuity future policy benefits are computed as the present value of future expected benefits.  Principal assumptions used in the establishment of policy reserves are mortality and investment yields.  Interest rates used to discount future expected benefits are set at the policy level and range from 2.25% to 9.0%.  The equivalent aggregate interest rate is 5.65%.  If the aggregate interest rate was reduced by 100 basis points, the present value of future expected benefits would increase by $19 million at December 31, 2011.

Reserves for universal life and deferred annuity plans are based upon the contract account balance without reduction for surrender charges.

**Investment Valuation**

We make estimates concerning the valuation of all investments.  Valuation techniques are used to derive the fair value of the available-for-sale and trading 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 was 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 for identical instruments in active markets not subject to adjustments or discounts.

- Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

- Level 3 Instruments whose significant value drivers are unobservable and reflect management s estimate of fair value based upon assumptions used by market participants in an orderly transaction as of the valuation date.

Level 1 primarily consists of publicly traded common stock, nonredeemable preferred stock and Treasury securities 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 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 municipal securities, asset backed securities, collateralized-mortgage obligations, foreign and domestic corporate bonds and redeemable preferred stock and certain nonredeemable preferred stock.

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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 comparable securities or non-binding broker quotes received from outside broker dealers based upon security type and market conditions. Remaining un-priced securities 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 certain private preferred stock and bond securities as well as collateralized debt and loan obligations.

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 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 a