

MERCURY GENERAL CORP
Form 10-Q
August 01, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarter Ended June 30, 2017

Commission File No. 001-12257

MERCURY GENERAL CORPORATION
(Exact name of registrant as specified in its charter)

California	95-2211612
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

4484 Wilshire Boulevard, Los Angeles, California 90010
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (323) 937-1060

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer	☒	Accelerated filer	☐
Non-accelerated filer	☐ (Do not check if a smaller reporting company)	Smaller reporting company	☐
Emerging growth company	☐		

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

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

At July 27, 2017, the Registrant had issued and outstanding an aggregate of 55,311,077 shares of its Common Stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2017 (unaudited)	December 31, 2016
ASSETS		
Investments, at fair value:		
Fixed maturity securities (amortized cost \$2,897,032; \$2,795,410)	\$2,952,084	\$2,814,553
Equity securities (cost \$395,011; \$331,770)	427,029	357,327
Short-term investments (cost \$280,304; \$375,700)	280,045	375,680
Total investments	3,659,158	3,547,560
Cash	261,425	220,318
Receivables:		
Premium	469,081	459,152
Accrued investment income	44,334	41,205
Other	18,961	24,635
Total receivables	532,376	524,992
Deferred policy acquisition costs	199,070	200,826
Fixed assets (net of accumulated depreciation \$330,219; \$319,429)	155,264	155,910
Deferred income taxes	34,347	45,277
Goodwill	42,796	42,796
Other intangible assets, net	22,949	25,625
Other assets	31,598	25,414
Total assets	\$4,938,983	\$4,788,718
LIABILITIES AND SHAREHOLDERS' EQUITY		
Loss and loss adjustment expense reserves	\$1,326,963	\$1,290,248
Unearned premiums	1,093,594	1,074,437
Notes payable	371,136	320,000
Accounts payable and accrued expenses	121,195	112,334
Current income taxes	12,706	9,962
Other liabilities	250,197	229,335
Total liabilities	3,175,791	3,036,316
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value:		
Authorized 70,000 shares; issued and outstanding 55,311; 55,289	96,565	95,529
Retained earnings	1,666,627	1,656,873
Total shareholders' equity	1,763,192	1,752,402
Total liabilities and shareholders' equity	\$4,938,983	\$4,788,718

See accompanying Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenues:				
Net premiums earned	\$797,666	\$779,321	\$1,587,436	\$1,546,406
Net investment income	31,901	31,414	63,070	61,069
Net realized investment gains	21,156	45,381	45,616	70,438
Other	2,124	1,887	4,229	4,010
Total revenues	852,847	858,003	1,700,351	1,681,923
Expenses:				
Losses and loss adjustment expenses	588,595	595,086	1,195,260	1,189,168
Policy acquisition costs	137,839	139,922	280,438	281,482
Other operating expenses	53,432	57,700	118,620	118,994
Interest	4,229	960	6,682	1,910
Total expenses	784,095	793,668	1,601,000	1,591,554
Income before income taxes	68,752	64,335	99,351	90,369
Income tax expense	17,119	15,462	20,738	18,173
Net income	\$51,633	\$48,873	\$78,613	\$72,196
Net income per share:				
Basic	\$0.93	\$0.88	\$1.42	\$1.31
Diluted	\$0.93	\$0.88	\$1.42	\$1.31
Weighted average shares outstanding:				
Basic	55,311	55,254	55,304	55,227
Diluted	55,323	55,322	55,318	55,294
Dividends paid per share	\$0.6225	\$0.6200	\$1.2450	\$1.2400

See accompanying Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30,	
	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$78,613	\$72,196
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	27,525	25,918
Net realized investment gains	(45,616)	(70,438)
Increase in premiums receivable	(9,929)	(23,456)
Changes in current and deferred income taxes	13,674	17,871
Decrease (increase) in deferred policy acquisition costs	1,756	(2,231)
Increase in loss and loss adjustment expense reserves	36,715	64,104
Increase in unearned premiums	19,157	30,824
Increase (decrease) in accounts payable and accrued expenses	9,068	(6,166)
Share-based compensation	56	71
Other, net	43,726	(2,901)
Net cash provided by operating activities	174,745	105,792
CASH FLOWS FROM INVESTING ACTIVITIES		
Fixed maturity securities available for sale in nature:		
Purchases	(440,294)	(491,231)
Sales	65,211	172,490
Calls or maturities	258,782	288,257
Equity securities available for sale in nature:		
Purchases	(368,896)	(337,598)
Sales	303,574	310,369
Calls	7,100	—
Changes in securities payable and receivable	(29,674)	(2,388)
Net decrease in short-term investments and purchased options	97,790	1,677
Purchase of fixed assets	(10,557)	(8,935)
Sale of fixed assets	—	2
Other, net	3	2,343
Net cash used in investing activities	(116,961)	(65,014)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid to shareholders	(68,859)	(68,515)
Employee taxes paid for withheld shares related to share-based compensation	—	(3,203)
Proceeds from stock options exercised	1,171	—
Net proceeds from issuance of senior notes	371,011	—
Payoff of principal on loan and credit facilities	(320,000)	—
Net cash used in financing activities	(16,677)	(71,718)
Net increase (decrease) in cash	41,107	(30,940)
Cash:		
Beginning of the year	220,318	264,221
End of period	\$261,425	\$233,281

SUPPLEMENTAL CASH FLOW DISCLOSURE

Interest paid	\$1,292	\$1,820
Income taxes paid	\$7,063	\$273

See accompanying Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. General

Consolidation and Basis of Presentation

The interim consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the “Company”). For the list of the Company’s subsidiaries, see Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. These interim financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”), which differ in some respects from those filed in reports to insurance regulatory authorities. The financial data of the Company included herein are unaudited. In the opinion of management, all material adjustments of a normal recurring nature have been made to present fairly the Company’s financial position at June 30, 2017 and the results of operations and cash flows for the periods presented. All intercompany transactions and balances have been eliminated.

Certain financial information that is normally included in annual financial statements prepared in accordance with GAAP, but that is not required for interim reporting purposes, has been omitted from the accompanying interim consolidated financial statements and related notes. Readers are urged to review the Company’s Annual Report on Form 10-K for the year ended December 31, 2016 for more complete descriptions and discussions. Operating results and cash flows for the six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about the effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates. See Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

Earnings per Share

Potentially dilutive securities representing approximately 28,000 and 48,000 shares of common stock for the three and six months ended June 30, 2016, respectively, were excluded from the computation of diluted earnings per common share because their effect would have been anti-dilutive. There were no potentially dilutive securities with anti-dilutive effect for the three and six months ended June 30, 2017.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred

policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company's deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. Deferred policy acquisition cost amortization was \$137.8 million and \$139.9 million for the three months ended June 30, 2017 and 2016, respectively, and \$280.4 million and \$281.5 million for the six months ended June 30, 2017 and 2016, respectively. The Company does not defer advertising expenditures but expenses them as incurred. The Company recorded net advertising expense of approximately \$20 million and \$24 million for the six months ended June 30, 2017 and 2016, respectively.

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2. Recently Issued Accounting Standards

In May 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-09, "Compensation - Stock Compensation (Topic 718), Scope of Modification Accounting." ASU 2017-09 provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. ASU 2017-09 will be effective for the Company beginning January 1, 2018 with early adoption permitted. The Company does not anticipate that ASU 2017-09 will have a material impact on its consolidated financial statements and related disclosures.

In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment." ASU 2017-04 removes the requirement to compare the implied fair value of goodwill with its carrying amount as part of Step 2 of the goodwill impairment test and requires an entity to recognize an impairment charge for the amount by which the carrying amount of a reporting unit exceeds its fair value. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company does not anticipate that ASU 2017-04 will have a material impact on its consolidated financial statements and related disclosures.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740), Intra-Entity Transfers of Assets Other Than Inventory." ASU 2016-16 requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Current GAAP prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party. ASU 2016-16 will be effective for the Company beginning January 1, 2018. The Company is evaluating the impact that ASU 2016-16 will have on its consolidated financial statements and related disclosures.

In August 2016, the FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments (Topic 230)." The new guidance is intended to reduce diversity in how certain transactions are classified in the consolidated statement of cash flows. ASU 2016-15 will be effective for the Company beginning January 1, 2018. The Company is evaluating the impact that ASU 2016-15 will have on its consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)." The amendments in this ASU replace the "incurred loss" methodology for recognizing credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of information including past events, current conditions and reasonable and supportable forecasts that affect the collectibility of reported amounts of financial assets that are not accounted for at fair value through net income, such as loans, certain debt securities, trade receivables, net investment in leases, off-balance sheet credit exposures and reinsurance receivables. Under the current GAAP incurred loss methodology, recognition of the full amount of credit losses is generally delayed until the loss is probable of occurring. Current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the probability threshold. ASU 2016-13 will be effective for the Company beginning with the first quarter ending March 31, 2020. While the Company is in the process of evaluating the impact of ASU 2016-13, it does not expect this ASU to have a material impact on its consolidated financial statements and related disclosures as most of its financial instruments with potential exposure to material credit losses are accounted for at fair value through net income.

In March 2016, the FASB issued ASU 2016-09, "Compensation - Stock Compensation (Topic 718)," which simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The Company adopted ASU 2016-09 for the quarter ended March 31, 2017. As a result of the adoption, the Company recognizes excess tax benefits in its provision for income taxes rather than paid-in capital. Additional amendments to accounting

for income taxes and minimum statutory withholding tax requirements had no impact to retained earnings as of January 1, 2017, where the cumulative effect of these changes are required to be recorded. The Company elected to continue to estimate forfeitures expected to occur to determine the amount of compensation cost to be recognized in each period. The Company also elected to apply the presentation requirements for cash flows related excess tax benefits retrospectively to all periods presented, which resulted in an increase to both net cash provided by operating activities and net cash used in financing activities of approximately \$904,000 for the six months ended June 30, 2016. The adoption of the presentation requirements for cash flows related to employee taxes paid for withheld shares resulted in an increase to both net cash provided by operating activities and net cash used in financing activities of approximately \$3,200,000 for the six months ended June 30, 2016.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which supersedes the guidance in Accounting Standards Codification ("ASC") 840, "Leases." ASU 2016-02 requires a lessee to recognize lease assets and lease liabilities resulting from all leases. ASU 2016-02 retains the distinction between a finance lease and an operating lease. Lessor accounting is largely unchanged from ASC 840. ASU 2016-02 will be effective for the Company beginning January 1, 2019. However, in transition, the Company will be required to recognize and measure leases at the beginning of the earliest period presented using

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a modified retrospective approach. While the Company is in the process of evaluating the impact of ASU 2016-02, it does not expect this ASU to have a material impact on its consolidated financial statements, except for recognizing lease assets and lease liabilities for its operating leases. The Company's lease obligations under various non-cancellable operating lease agreements amounted to approximately \$27,000,000 at December 31, 2016.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in this ASU address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01: (1) requires equity investments (except those accounted for under the equity method or those that result in the consolidation of the investee) to be measured at fair value with changes in the fair value recognized in net income; (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (4) requires the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the notes to the financial statements; and (6) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. ASU 2016-01 will be effective for the Company beginning January 1, 2018. The Company does not anticipate that ASU 2016-01 will have a material impact on its consolidated financial statements and related disclosures.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." ASU 2014-09 requires entities to apply a five-step model to determine the amount and timing of revenue recognition. The model specifies, among other criteria, that revenue should be recognized when an entity transfers control of goods or services to a customer in the amount to which the entity expects to be entitled. In August 2015, the FASB issued ASU 2015-14, "Revenue from Contracts with Customers (Topic 606), Deferral of the Effective Date," which deferred the effective date of ASU 2014-09 for the Company to January 1, 2018. Subsequently, the FASB has issued additional ASUs on Topic 606 that do not change the core principle of the guidance in ASU 2014-09 but merely clarify certain aspects of it. The additional ASUs will also be effective for the Company beginning January 1, 2018. Two methods of transition are permitted upon adoption: full retrospective and modified retrospective. The Company is evaluating both methods of transition and it is currently anticipated that a modified retrospective adoption approach will be used. However, as the accounting for insurance contracts is outside of the scope of ASU 2014-09, the Company does not expect the adoption of this ASU to have a material impact on its consolidated financial statements and related disclosures.

3. Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, options sold, total return swaps, accounts payable, and secured and unsecured notes payable. Due to their short-term maturities, the carrying values of receivables and accounts payable approximate their fair values. All investments are carried at fair value in the consolidated balance sheets.

The following table presents the estimated fair values of financial instruments:

June 30,	December 31,
2017	2016

(Amounts in thousands)

Assets

Investments	\$3,659,158	\$3,547,560
Total return swaps —		667

Liabilities

Total return swaps	\$ 1,725	\$ 765
Options sold	104	20
Secured notes	—	140,000
Unsecured notes	380,059	180,000

Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains

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and losses are included in net realized investment gains in the consolidated statements of operations. See Note 4. Fair Value Option for additional information.

Options Sold

The Company writes covered call options through listed and over-the-counter exchanges. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company as realized gains from investments on the expiration date. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security or currency in determining whether the Company has realized a gain or loss. The Company, as writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option. Liabilities for covered call options are included in other liabilities in the Company's consolidated balance sheets.

Total Return Swaps

The fair values of the total return swaps reflect the estimated amounts that, upon termination of the contracts, would be received for selling an asset or paid to transfer a liability in an orderly transaction.

Secured Notes

The fair values of the Company's \$120 million secured note and \$20 million secured note at December 31, 2016 approximate their carrying values.

Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured note at June 30, 2017 was obtained from a third party pricing service. The fair value of the Company's \$180 million unsecured note at December 31, 2016 approximates its carrying value.

For additional disclosures regarding methods and assumptions used in estimating fair values, see Note 5. Fair Value Measurements.

4. Fair Value Option

The Company applies the fair value option to all fixed maturity and equity investment securities and short-term investments at the time an eligible item is first recognized. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as the expansion of the use of fair value measurement by the Company consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

Gains or losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment gains or losses in the Company's consolidated statements of operations, while interest and dividend income on investment holdings are recognized on an accrual basis at each measurement date and are included in net investment income in the Company's consolidated statements of operations.

The following table presents gains (losses) due to changes in fair value of investments that are measured at fair value pursuant to the application of the fair value option:

Three Months		Six Months Ended	
Ended June 30,		June 30,	
2017	2016	2017	2016

(Amounts in thousands)

Fixed maturity securities	\$25,622	\$28,871	\$35,909	\$40,434
Equity securities	(5,080)	8,666	6,462	15,573
Short-term investments	(267)	(410)	(240)	(349)
Total gains	\$20,275	\$37,127	\$42,131	\$55,658

5. Fair Value Measurements

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an

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orderly transaction between market participants at the measurement date using the exit price. Accordingly, when market observable data are not readily available, the Company's own assumptions are used to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based on the level of judgment associated with inputs used to measure their fair values and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Pricing inputs are other than quoted prices in active markets, which are based on the following:

- Quoted prices for similar assets or liabilities in active markets;

Level 2

- Quoted prices for identical or similar assets or liabilities in non-active markets; or

- Either directly or indirectly observable inputs as of the reporting date.

Level 3 Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on 99.8% of its portfolio from an independent pricing service. For 0.2% of its portfolio, classified as Level 3, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from at least one knowledgeable outside security broker to determine the fair value as of June 30, 2017.

Level 1 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets.

Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.

U.S. government bonds and agencies/Short-term bonds: Valued using unadjusted quoted market prices for identical assets in active markets.

Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets in active markets.

Options sold: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on unadjusted quoted prices for identical instruments in active markets.

Level 2 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability.

Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment

portfolio.

Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by residential and commercial mortgage loans valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes,

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for identical or similar assets in active markets. The Company had holdings of \$24.8 million and \$30.0 million at June 30, 2017 and December 31, 2016, respectively, in commercial mortgage-backed securities.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Total return swaps: Valued based on multi-dimensional models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.

Collateralized loan obligations: Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets.

Other asset-backed securities: Comprised of securities that are collateralized by non-mortgage assets, such as automobile loans, valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets.

Level 3 Measurements - Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Private equity funds: Valued based on underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets taking into consideration unobservable inputs related to liquidity assumptions.

The Company's financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains or losses in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair values:

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June 30, 2017

	Level 1	Level 2	Level 3	Total
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(Amounts in thousands)

Assets

Fixed maturity securities:

U.S. government bonds and agencies	\$11,735	\$—	\$—	\$11,735
Municipal securities	—	2,603,646	—	2,603,646
Mortgage-backed securities	—	33,551	—	33,551
Corporate securities	—	165,880	—	165,880
Collateralized loan obligations	—	83,465	—	83,465
Other asset-backed securities	—	53,807	—	53,807
Total fixed maturity securities	11,735	2,940,349	—	2,952,084

Equity securities:

Common stock	392,514	—	—	392,514
Non-redeemable preferred stock	—	25,751	—	25,751
Private equity funds	—	—	8,764	8,764
Total equity securities	392,514	25,751	8,764	427,029

Short-term investments:

Short-term bonds	29,997	15,994	—	45,991
Money market instruments	234,054	—	—	234,054
Total short-term investments	264,051	15,994	—	280,045
Total assets at fair value	\$668,300	\$2,982,094	\$8,764	\$3,659,158

Liabilities

Other liabilities:

Total return swaps	\$—	\$1,725	\$—	\$1,725
Options sold	104	—	—	104
Total liabilities at fair value	\$104	\$1,725	\$—	\$1,829

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December 31, 2016				
	Level 1	Level 2	Level 3	Total
(Amounts in thousands)				
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	\$12,275	\$—	\$—	\$12,275
Municipal securities	—	2,449,292	—	2,449,292
Mortgage-backed securities	—	39,777	—	39,777
Corporate securities	—	189,688	—	189,688
Collateralized loan obligations	—	86,525	—	86,525
Other asset-backed securities	—	36,996	—	36,996
Total fixed maturity securities	12,275	2,802,278	—	2,814,553
Equity securities:				
Common stock	316,450	—	—	316,450
Non-redeemable preferred stock	—	31,809	—	31,809
Private equity fund	—	—	9,068	9,068
Total equity securities	316,450	31,809	9,068	357,327
Short-term investments:				
Short-term bonds	70,393	20,233	—	90,626
Money market instruments	285,054	—	—	285,054
Total short-term investments	355,447	20,233	—	375,680
Other assets:				
Total return swaps	—	667	—	667
Total assets at fair value	\$684,172	\$2,854,987	\$9,068	\$3,548,227
Liabilities				
Other liabilities:				
Total return swaps	\$—	\$765	\$—	\$765
Options sold	20	—	—	20
Total liabilities at fair value	\$20	\$765	\$—	\$785

The following table presents a summary of changes in fair value of Level 3 financial assets and financial liabilities:

	Private Equity Fund			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
(Amounts in thousands)				
Beginning balance	\$9,018	\$8,991	\$9,068	\$10,431
Realized losses included in earnings	(254)	(19)	(304)	(1,459)
Ending balance	\$8,764	\$8,972	\$8,764	\$8,972
The amount of total losses for the period included in earnings attributable to assets still held at June 30	\$(254)	\$(19)	\$(304)	\$(1,459)

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the six months ended June 30, 2017 and 2016.

At June 30, 2017, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

Financial Instruments Disclosed, But Not Carried, at Fair Value

The following tables present the carrying value and fair value of the Company's financial instruments disclosed, but not carried, at fair value, and the level within the fair value hierarchy at which such instruments are categorized:

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June 30, 2017

Carrying Value	Fair Value	Level 1	Level 2	Level 3
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(Amounts in thousands)

Liabilities

Notes payable:

Unsecured notes	\$371,136	\$380,059	\$ —	—\$380,059	\$ —
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December 31, 2016

Carrying Value	Fair Value	Level 1	Level 2	Level 3
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(Amounts in thousands)

Liabilities

Notes payable:

Secured notes	\$140,000	\$140,000	\$ —	—\$140,000	\$ —
Unsecured notes	180,000	180,000	—	180,000	—

Secured Notes

The fair values of the Company's \$120 million secured note and \$20 million secured note at December 31, 2016 were estimated based on assumptions and inputs, such as the market value of underlying collateral and reset rates, for similarly termed notes that are observable in the market. In addition, the fair values of these secured notes approximate their carrying values, as the interest rates on these securities are variable and approximate current market interest rates.

Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured note at June 30, 2017 was obtained from a third party pricing service and pricing was based on the spreads above the risk-free yield curve. These spreads are generally obtained from the new issue market, secondary trading and broker-dealer quotes.

The fair value of the Company's \$180 million unsecured note at December 31, 2016 was based on the unadjusted quoted price for similar notes in active markets. In addition, the fair value of this unsecured note approximates its carrying value, as the interest rate on this security is variable and approximates current market interest rates.

See Note 11. Notes Payable for additional information on secured and unsecured notes.

6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risk managed by using derivative instruments is equity price risk. Equity contracts (options sold) on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities.

The Company also enters into derivative contracts to enhance returns on its investment portfolio.

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle formed and consolidated by the Company, entered into a total return swap agreement with Citibank. Under the agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$30 million of U.S.

Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 145 basis points prior to the renewal of the agreement in January 2017 and LIBOR plus 128 basis points subsequent to the renewal, on approximately \$104 million and \$108 million of underlying obligations as of June 30, 2017 and December 31, 2016, respectively. The agreement had an initial term of one year, subject to annual renewal. In January 2017, the agreement was renewed for an additional year expiring February 17, 2018, and the interest rate was changed to LIBOR plus 128 basis points.

On August 9, 2013, Animas Funding LLC (“AFL”), a special purpose investment vehicle formed and consolidated by the Company, entered into a three-year total return swap agreement with Citibank, which has been renewed for an additional one-year term through February 17, 2018. During June 2017, the total portfolio of underlying obligations was liquidated, and the total return swap agreement between AFL and Citibank was terminated on July 7, 2017. Under the agreement, AFL received the income equivalent on underlying obligations due to Citibank and paid to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap was secured by approximately \$40 million of U.S. Treasuries as collateral, which

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were included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 135 basis points prior to the amendment of the agreement in January 2017 and LIBOR plus 128 basis points subsequent to the amendment, on approximately \$152 million of underlying obligations as of December 31, 2016.

The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative (losses) gains in the consolidated statements of operations:

	Asset Derivatives	Liability Derivatives	
	June 30, 2016	June 30, 2017	December 31, 2016
(Amounts in thousands)			
Total return swaps - Other assets	\$— 667	\$—	\$ —
Options sold - Other liabilities	—	104	20
Total return swaps - Other liabilities	—	1,725	765
Total derivatives	\$— 667	\$1,829	\$ 785
(Losses) Gains Recognized in Income			
Three Months Six Months			
Ended June 30, Ended June 30,			
2017 2016 2017 2016			

(Amounts in thousands)			
Total return swaps - Net realized investment (losses) gains	\$(1,634)	\$2,581	\$(2,654) \$3,744
Options sold - Net realized investment gains	1,005	1,350	1,301 2,294
Total	\$(629)	\$3,931	\$(1,353) \$6,038

Most options sold consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. See Note 5. Fair Value Measurements for additional disclosures regarding options sold.

7. Goodwill and Other Intangible Assets

Goodwill

There were no changes in the carrying amount of goodwill during the three and six months ended June 30, 2017 and 2016. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three and six months ended June 30, 2017 and 2016. All of the Company's goodwill is associated with the Property and Casualty business segment (See Note 13. Segment Information for additional information on the reportable business segment).

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Other Intangible Assets

The following table presents the components of other intangible assets:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Useful Lives
	(Amounts in thousands)			(in years)
As of June 30, 2017:				
Customer relationships	\$52,430	\$ (41,472)	\$ 10,958	11
Trade names	15,400	(5,454)	9,946	24
Technology	4,300	(3,655)	645	10
Insurance license	1,400	—	1,400	Indefinite
Total other intangible assets, net	\$73,530	\$ (50,581)	\$ 22,949	
As of December 31, 2016:				
Customer relationships	\$52,430	\$ (39,332)	\$ 13,098	11
Trade names	15,400	(5,133)	10,267	24
Technology	4,300	(3,440)	860	10
Insurance license	1,400	—	1,400	Indefinite
Total other intangible assets, net	\$73,530	\$ (47,905)	\$ 25,625	

Other intangible assets are reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three and six months ended June 30, 2017 and 2016.

Other intangible assets with definite useful lives are amortized on a straight-line basis over their useful lives. Other intangible assets amortization expense was \$1.3 million and \$1.5 million for the three months ended June 30, 2017 and 2016, respectively, and \$2.7 million and \$3.0 million for the six months ended June 30, 2017 and 2016, respectively.

The following table presents the estimated future amortization expense related to other intangible assets as of June 30, 2017:

Year	Amortization Expense (Amounts in thousands)
Remainder of 2017	\$ 2,673
2018	5,335
2019	4,905
2020	758
2021	738
Thereafter	7,140
Total	\$ 21,549

8. Share-Based Compensation

Share-based compensation expense for all share-based payment awards granted or modified is based on the estimated grant-date fair value. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award. As of June 30, 2017, all outstanding stock options have a term of ten years from the date of grant and become exercisable in four equal installments on the first through fourth anniversaries of the grant date. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

In February 2015, the Company's Board of Directors adopted the 2015 Incentive Award Plan (the "2015 Plan"), replacing the 2005 Equity Incentive Plan (the "2005 Plan") which expired in January 2015. The 2015 Plan was

approved at the Company's Annual Meeting of Shareholders in May 2015. A maximum of 4,900,000 shares of common stock are authorized for issuance under the 2015 Plan upon exercise of stock options, stock appreciation rights and other awards, or upon vesting of restricted stock unit ("RSU") or deferred stock awards. As of June 30, 2017, 184,500 RSUs were outstanding and 4,715,500 shares of common stock were available for future issuances under the 2015 Plan.

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The Compensation Committee of the Company's Board of Directors granted RSU awards to the Company's senior management and key employees which will vest based upon the Company's performance during three-year performance periods ending on December 31, 2017 and 2018:

	Grant Year	
	2016	2015
Three-year performance period ending December 31,	2018	2017
Vesting shares, target (net of forfeited)	90,750	93,750
Vesting shares, maximum (net of forfeited)	170,156	175,781

The RSUs vest at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company's performance during the performance period achieves the threshold established by the Compensation Committee of the Company's Board of Directors. Performance thresholds are based on the Company's cumulative underwriting income, annual underwriting income, and net earned premium growth. In March 2017, a total of approximately \$3.6 million was paid upon the vesting of 61,445 RSUs awarded in 2014 resulting from the attainment of performance goals above the target threshold during the three-year performance period ended December 31, 2016.

In February 2016, 88,074 shares of common stock, net of 58,822 shares withheld for payroll taxes, were issued upon the vesting of 146,896 RSUs awarded in 2013 resulting from the attainment of performance goals above the target threshold during the three-year performance period ended December 31, 2015.

As of June 30, 2017, 5,000 and 5,500 target RSUs granted in 2016 and 2015, respectively, were forfeited because the recipients were no longer employed by the Company.

The fair value of each RSU grant was determined based on the market price of the Company's common stock on the grant date. Compensation cost is recognized based on management's best estimate that performance goals will be achieved. If such goals are not met, no compensation cost will be recognized and any recognized compensation cost will be reversed.

No stock options or RSUs were awarded during the six months ended June 30, 2017.

9. Income Taxes

For financial statement purposes, the Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return only if, the positions are "more-likely-than-not" sustainable. Once this threshold has been met, the Company's measurement of its expected tax benefits is recognized in its financial statements.

There was a \$0.3 million increase to the total amount of unrecognized tax benefit related to tax uncertainties during the six months ended June 30, 2017. The increase was the result of tax positions taken regarding state tax apportionment issues based on management's best judgment given the facts, circumstances, and information available at the reporting date. The Company does not expect any changes in such unrecognized tax benefits to have a significant impact on its consolidated financial statements within the next 12 months.

The Company and its subsidiaries file income tax returns with the Internal Revenue Service and the taxing authorities of various states. Tax years that remain subject to examination by major taxing jurisdictions are 2013 through 2015 for federal taxes, and 2003 through 2015 for California state taxes. The Company is currently under examination by the California Franchise Tax Board ("FTB") for tax years 2003 through 2013. The FTB issued Notices of Proposed Assessments ("NPAs") to the Company for tax years 2003 through 2010, which the Company formally protested. The proposed adjustments for tax years 2003 through 2006 were affirmed following an administrative protest process with the FTB examination. The Company is in settlement discussions with the FTB and believes a reasonable settlement could be reached during 2017 with regard to tax years 2003 through 2010. If a reasonable settlement is not reached, the Company intends to pursue other options, including a formal hearing with the State Board of Equalization, an appeal with the California Office of Tax Appeals, or litigation in superior court. The FTB has not yet issued NPAs for the 2011 through 2013 tax years. Management believes that the resolution of these examinations and assessments will

not have a material impact on the Company's consolidated financial statements.

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will

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be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates or laws is recognized in earnings in the period that includes the enactment date.

At June 30, 2017, the Company's deferred income taxes were in a net asset position, which included a combination of ordinary and capital deferred tax benefits. In assessing the Company's ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

10. Loss and Loss Adjustment Expense Reserves

The following table presents the activity in loss and loss adjustment expense reserves:

	Six Months Ended June 30,	
	2017	2016
	(Amounts in thousands)	
Gross reserves at January 1	\$ 1,290,248	\$ 1,146,688
Less reinsurance recoverable	(13,161)	(14,253)
Net reserves at January 1	1,277,087	1,132,435
Incurred losses and loss adjustment expenses related to:		
Current year	1,181,108	1,127,203
Prior years	14,152	61,965
Total incurred losses and loss adjustment expenses	1,195,260	1,189,168
Loss and loss adjustment expense payments related to:		
Current year	685,137	650,741
Prior years	471,973	474,124
Total payments	1,157,110	1,124,865
Net reserves at June 30	1,315,237	1,196,738
Reinsurance recoverable	11,726	14,055
Gross reserves at June 30	\$ 1,326,963	\$ 1,210,793

The increase in the provision for insured events of prior years in 2017 of approximately \$14.2 million was primarily attributable to higher than estimated California property losses.

The increase in the provision for insured events of prior years in 2016 of approximately \$62.0 million primarily resulted from the re-estimation of losses for California and Florida automobile liability coverages.

For the six months ended June 30, 2017 and 2016, the Company recorded catastrophe losses of approximately \$40 million and \$19 million, respectively. The 2017 catastrophe losses were primarily due to severe rainstorms in California, as well as storms and tornadoes in Oklahoma and Texas. The Winter of 2017 was extremely wet in

California, setting new precipitation records in parts of the state. The 2016 catastrophe losses were mainly attributable to severe storms in Texas and northern California.

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11. Notes Payable

Notes payable consists of the following:

	Lender	Interest Rate	Maturity Date	June 30, 2017	December 31, 2016
(Amounts in thousands)					
Secured credit facility ⁽¹⁾	Bank of America	LIBOR plus 40 basis points	December 3, 2018	\$—	\$ 120,000
Secured loan ⁽¹⁾	Union Bank	LIBOR plus 40 basis points	December 3, 2017	—	20,000
Unsecured credit facility ⁽¹⁾	Bank of America and Union Bank	LIBOR plus 112.5-162.5 basis points	December 3, 2019	—	180,000
Senior unsecured notes ⁽²⁾	Publicly traded	4.40%	March 15, 2027	375,000	—
Unsecured credit facility ⁽³⁾	Bank of America and Wells Fargo Bank	LIBOR plus 112.5-162.5 basis points	March 29, 2022	—	—
Total principal amount				375,000	320,000
Less unamortized discount and debt issuance costs ⁽⁴⁾				3,864	—
Total debt				\$371,136	\$ 320,000

(1) On March 8, 2017, the loan and credit facility agreements were terminated and the Company repaid the total outstanding amounts with the proceeds from its public offering of \$375 million of senior notes.

On March 8, 2017, the Company completed a public debt offering issuing \$375 million of senior notes. The notes are unsecured, senior obligations of the Company with a 4.40% annual coupon payable on March 15 and September 15 of each year commencing September 15, 2017. These notes mature on March 15, 2027. The

(2) Company used the proceeds from the notes to pay off amounts outstanding under the existing loan and credit facilities and for general corporate purposes. The Company incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective annualized interest rate including debt issuance costs of approximately 4.45%.

On March 29, 2017, the Company entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 17.5% at June 30, 2017, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of July 27, 2017, there have been no borrowings under this facility.

(3) The unamortized discount and debt issuance costs of approximately \$3.9 million are associated with the publicly traded \$375 million senior unsecured notes. These are amortized to interest expense over the life of the notes, and the unamortized balance is presented in the Company's consolidated balance sheets as a direct deduction from the carrying amount of the debt. The unamortized debt issuance cost of approximately \$0.2 million associated with the \$50 million five-year unsecured revolving credit facility maturing on March 29, 2022 is included in other assets in the Company's consolidated balance sheets and amortized to interest expense over the term of the credit facility.

12. Contingencies

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, "2004 NNC") alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer's insurance broker. The California DOI sought to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker

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fee, to impose a penalty for each policy on which the Company allegedly used a misleading advertisement, and to suspend certificates of authority for a period of one year. In January 2012, the administrative law judge bifurcated the 2004 NNC between (a) the California DOI's order to show cause (the "OSC"), in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance (the "NNC"), in which the California DOI asserts the unlawful rate allegations. In February 2012, the administrative law judge ("ALJ") submitted a proposed decision dismissing the NNC, but the Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior Court in April 2012, and the Commissioner responded with a demurrer. Following a hearing, the Superior Court sustained the Commissioner's demurrer, based on the Company's failure to exhaust its administrative remedies, and the Company appealed. The Court of Appeal affirmed the Superior Court's ruling that the Company was required to exhaust its administrative remedies, but expressly preserved for later appeal the legal basis for the ALJ's dismissal: violation of the Company's due process rights. Following an evidentiary hearing in April 2013, post-hearing briefs, and an unsuccessful mediation, the ALJ closed the evidentiary record on April 30, 2014. Although a proposed decision was to be submitted to the Commissioner on or before June 30, 2014, after which the Commissioner would have 100 days to accept, reject or modify the proposed decision, the proposed decision was not submitted until December 8, 2014. On January 7, 2015, the Commissioner adopted the ALJ's proposed decision, which became the Commissioner's adopted order (the "Order"). The decision and Order found that from the period July 1, 1996, through 2006, the Company's "brokers" were actually operating as "de facto agents" and that the charging of "broker fees" by these producers constituted the charging of "premium" in excess of the Company's approved rates, and assessed a civil penalty in the amount of \$27.6 million against the Company. On February 9, 2015, the Company filed a Writ of Administrative Mandamus and Complaint for Declaratory Relief (the "Writ") in the Orange County Superior Court seeking, among other things, to require the Commissioner to vacate the Order, to stay the Order while the Superior Court action is pending, and to judicially declare as invalid the Commissioner's interpretation of certain provisions of the California Insurance Code. Subsequent to the filing of the Writ, a consumer group petitioned and was granted the right to intervene in the Superior Court action. The Court did not order a stay, and the \$27.6 million assessed penalty was paid in March 2015. The Company filed an amended Writ on September 11, 2015, adding an explicit request for a refund of the penalty, with interest.

On August 12, 2016, the Superior Court issued its ruling on the Writ, for the most part granting the relief sought by the Company. The Superior Court found that the Commissioner and the California DOI did commit due process violations, but declined to dismiss the case on those grounds. The Superior Court also agreed with the Company that the broker fees at issue were not premium, and that the penalties imposed by the Commissioner were improper, and therefore vacated the Order imposing the penalty. The Superior Court entered final judgment on November 17, 2016, issuing a writ requiring the Commissioner to refund the entire penalty amount within 120 days, plus prejudgment interest at the statutory rate of 7%. On January 12, 2017, the California DOI filed a notice of appeal of the Superior Court's judgment entered on November 17, 2016. While the appeal is still pending, the California DOI returned the entire penalty amount plus accrued interest, a total of \$30.9 million, to the Company in June 2017 in order to avoid accruing further interest. Because the matter has been appealed, the Company has not yet recognized the \$30.9 million as a gain in the consolidated income statement; instead, the Company recorded the \$30.9 million in other liabilities in the consolidated balance sheet at June 30, 2017. The Company had filed a motion to dismiss the false advertising portion of the case based on the Superior Court's findings, but the ALJ denied that motion after the appeal was filed. The ALJ did, however, grant the Company's alternative request to stay further proceedings pending the final determination of the appeal. The Company has accrued a liability for the estimated cost to continue to defend itself in the false advertising OSC. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the false advertising OSC will be material to its financial position.

The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses

may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

13. Segment Information

The Company is primarily engaged in writing personal automobile insurance and provides related property and casualty insurance products to its customers through 14 subsidiaries in 11 states, principally in California.

The Company has one reportable business segment - the Property and Casualty business segment.

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The Company's Chief Operating Decision Maker evaluates operating results based on pre-tax underwriting results which is calculated as net premiums earned less (a) losses and loss adjustment expenses and (b) underwriting expenses (policy acquisition costs and other operating expenses).

Expenses are allocated based on certain assumptions that are primarily related to premiums and losses. The Company's net investment income, net realized investment gains or losses, other income, and interest expense are excluded in evaluating pretax underwriting profit. The Company does not allocate its assets, including investments, or income taxes in evaluating pre-tax underwriting profit.

Property and Casualty Lines

The Property and Casualty business segment offers several insurance products to the Company's individual customers and small business customers. These insurance products are: private passenger automobile which is the Company's primary business, and related insurance products such as homeowners, commercial automobile and commercial property. These related insurance products are primarily sold to the Company's individual customers and small business customers, which increases retention of the Company's private passenger automobile client base. The insurance products comprising the Property and Casualty business segment are sold through the same distribution channels, mainly through independent and 100% owned insurance agents, and go through a similar underwriting process.

Other Lines

The Other business segment represents net premiums written and earned from an operating segment that does not meet the quantitative thresholds required to be considered a reportable segment. This operating segment offers automobile mechanical protection warranties which are primarily sold through automobile dealerships and credit unions.

The following tables present the Company's operating results by reportable segment:

	Three Months Ended			June 30, 2016		
	June 30, 2017			June 30, 2016		
	Property & Casualty	Other	Total	Property & Casualty	Other	Total
(Amounts in millions)						
Net premiums earned	\$789.0	\$ 8.7	\$797.7	\$768.6	\$10.7	\$779.3
Less:						
Losses and loss adjustment expenses	584.2	4.4	588.6	589.4	5.7	595.1
Underwriting expenses	187.3	4.0	191.3	193.4	4.2	197.6
Underwriting gain (loss)	17.5	0.3	17.8	(14.2)	0.8	(13.4)
Investment income			31.9			31.5
Net realized investment gains			21.1			45.4
Other income			2.1			1.9
Interest expense			(4.2)			(1.0)
Pre-tax income			\$68.8			\$64.3
Net income			\$51.6			\$48.9

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	Six Months Ended			June 30, 2016		
	Property & Casualty	Other	Total	Property & Casualty	Other	Total
(Amounts in millions)						
Net premiums earned	\$1,569.7	\$17.7	\$1,587.4	\$1,524.4	\$22.0	\$1,546.4
Less:						
Losses and loss adjustment expenses	1,186.0	9.3	1,195.3	1,177.4	11.8	1,189.2
Underwriting expenses	391.1	7.9	399.0	391.3	9.1	400.4
Underwriting (loss) gain	(7.4)	0.5	(6.9)	(44.3)	1.1	(43.2)
Investment income			63.1			61.1
Net realized investment gains			45.6			70.4
Other income			4.3			4.0
Interest expense			(6.7)			(1.9)
Pre-tax income			\$99.4			\$90.4
Net income			\$78.6			\$72.2

The following tables present the Company's net premiums earned and direct premiums written by line of insurance business:

	Three Months Ended			June 30, 2016		
	Property & Casualty	Other	Total	Property & Casualty	Other	Total
(Amounts in millions)						
Private passenger automobile	\$617.3	\$—	\$617.3	\$607.1	\$—	\$607.1
Homeowners	108.3	—	108.3	102.0	—	102.0
Commercial automobile	42.4	—	42.4	39.9	—	39.9
Other	21.0	8.7	29.7	19.6	10.7	30.3
Net premiums earned	\$789.0	\$8.7	\$797.7	\$768.6	\$10.7	\$779.3
Private passenger automobile	\$600.1	\$—	\$600.1	\$595.4	\$—	\$595.4
Homeowners	122.7	—	122.7	116.3	—	116.3
Commercial automobile	45.1	—	45.1	42.4	—	42.4
Other	24.2	8.5	32.7	23.0	6.9	29.9
Direct premiums written	\$792.1	\$8.5	\$800.6	\$777.1	\$6.9	\$784.0

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	Six Months Ended					
	June 30, 2017			June 30, 2016		
	Property			Property		
	&	Other	Total	&	Other	Total
	Casualty			Casualty		
(Amounts in millions)						
Private passenger automobile	\$1,230.5	\$—	\$1,230.5	\$1,206.1	\$—	\$1,206.1
Homeowners	214.0	—	214.0	201.5	—	201.5
Commercial automobile	83.7	—	83.7	78.6	—	78.6
Other	41.5	17.7	59.2	38.2	22.0	60.2
Net premiums earned	\$1,569.7	\$17.7	\$1,587.4	\$1,524.4	\$22.0	\$1,546.4
Private passenger automobile	\$1,239.1	\$—	\$1,239.1	\$1,227.2	\$—	\$1,227.2
Homeowners	226.5	—	226.5	215.4	—	215.4
Commercial automobile	88.1	—	88.1	83.3	—	83.3
Other	47.0	14.2	61.2	43.9	14.3	58.2
Direct premiums written	\$1,600.7	\$14.2	\$1,614.9	\$1,569.8	\$14.3	\$1,584.1

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for certain forward-looking statements. Certain statements contained in this report are forward-looking statements based on the Company's current expectations and beliefs concerning future developments and their potential effects on the Company. There can be no assurance that future developments affecting the Company will be those anticipated by the Company. Actual results may differ from those projected in the forward-looking statements. These forward-looking statements involve significant risks and uncertainties (some of which are beyond the control of the Company) and are subject to change based upon various factors, including but not limited to the following risks and uncertainties: changes in the demand for the Company's insurance products, inflation and general economic conditions, including general market risks associated with the Company's investment portfolio; the accuracy and adequacy of the Company's pricing methodologies; catastrophes in the markets served by the Company; uncertainties related to estimates, assumptions and projections generally; the possibility that actual loss experience may vary adversely from the actuarial estimates made to determine the Company's loss reserves in general; the Company's ability to obtain and the timing of the approval of premium rate changes for insurance policies issued in states where the Company operates; legislation adverse to the automobile insurance industry or business generally that may be enacted in the states where the Company operates; the Company's success in managing its business in non-California states; the presence of competitors with greater financial resources and the impact of competitive pricing and marketing efforts; the ability of the Company to successfully manage its claims organization outside of California; the Company's ability to successfully allocate the resources used in the states with reduced or exited operations to its operations in other states; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions and trends in litigation and health care and auto repair costs and marketing efforts; and legal, regulatory and litigation risks. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as the result of new information, future events or otherwise. For a more detailed discussion of some of the foregoing risks and uncertainties, see the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 9, 2017.

OVERVIEW

A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of weather and natural disasters on losses, general economic conditions, the general regulatory environment in states in which an insurer operates, state regulation of insurance including premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty insurance industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a significant impact on the Company's ability to grow and retain business.

This section discusses some of the relevant factors that management considers in evaluating the Company's performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management's discussion and analysis, the Company's consolidated financial statements and notes thereto, and all other items contained within this Quarterly Report on Form 10-Q.

B. Business

The Company is primarily engaged in writing personal automobile insurance through 14 insurance subsidiaries ("Insurance Companies") in 11 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical protection, and umbrella insurance. The Company's insurance policies are mostly sold through independent agents who receive a commission for selling policies. The Company believes that it has thorough underwriting and claims handling processes that, together with its agent relationships, provide the

Company with competitive advantages.

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The following tables present direct premiums written, by state and line of insurance business, during the six months ended June 30, 2017 and 2016:

Six Months Ended June 30, 2017
(Dollars in thousands)

	Private Passenger Automobile	Homeowners	Commercial Automobile	Other Lines	Total		
California	\$1,051,078	\$194,157	\$48,292	\$55,441	\$1,348,968	83.5	%
Florida ⁽¹⁾	74,664	6	10,077	411	85,158	5.3	%
Other states ⁽²⁾	113,406	32,349	29,718	5,271	180,744	11.2	%
Total	\$1,239,148	\$226,512	\$88,087	\$61,123	\$1,614,870	100.0	%
	76.7	% 14.0	% 5.5	% 3.8	% 100.0		%

Six Months Ended June 30, 2016
(Dollars in thousands)

	Private Passenger Automobile	Homeowners	Commercial Automobile	Other Lines	Total		
California	\$1,021,048	\$181,879	\$41,373	\$51,990	\$1,296,290	81.8	%
Florida ⁽¹⁾	81,306	6	14,837	737	96,886	6.1	%
Other states ⁽²⁾	124,891	33,561	27,140	5,372	190,964	12.1	%
Total	\$1,227,245	\$215,446	\$83,350	\$58,099	\$1,584,140	100.0	%
	77.4	% 13.6	% 5.3	% 3.7	% 100.0		%

⁽¹⁾ The Company is writing and expects to continue writing nominal premiums in the Florida homeowners market.

⁽²⁾ No individual state accounted for more than 4% of total direct premiums written.

C. Regulatory and Legal Matters

The Department of Insurance (“DOI”) in each state in which the Company operates is responsible for conducting periodic financial, market conduct, and rating and underwriting examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices.

The following table presents a summary of current examinations:

State	Exam Type	Period Under Review	Status
GA	Financial	2011 to 2013	Received final report.
CA	Market Conduct Claims	2015	Provided answers to inquiries and awaiting DOI follow-up.
CA	Rating and Underwriting	2014	Field work is completed. Awaiting draft report.
VA	Market Conduct	2014 to 2015	Received draft report and awaiting final report.

During the course of and at the conclusion of these examinations, the examining DOI generally reports findings to the Company. None of the findings reported to date are expected to be material to the Company’s financial position. In March 2017, the California DOI approved a 6.9% rate increase on California Automobile Insurance Company's private passenger automobile line of insurance business, which represented approximately 14% of the Company's total net premiums earned in the first half of 2017. This rate increase became effective in May 2017. In addition, in April

2017, the California DOI approved a 6.9% rate increase on the California homeowners line of business, which represented approximately 11% of the Company's total net premiums earned in the first half of 2017. This rate increase is effective in August 2017.

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

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The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2016, and Note 12. Contingencies of the Notes to Consolidated Financial Statements of this Quarterly Report.

D. Critical Accounting Policies and Estimates

Loss and Loss Adjustment Expense Reserves ("Loss Reserves")

Preparation of the Company's consolidated financial statements requires management's judgment and estimates. The most significant is the estimate of loss reserves. Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the loss reserve that is required. A key assumption in estimating loss reserves is the degree to which the historical data used to analyze reserves will be predictive of ultimate claim costs on incurred claims. Changes in the regulatory and legal environments, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact this assumption. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims.

The Company calculates a loss reserve point estimate rather than a range. There is inherent uncertainty with estimates and this is particularly true with loss reserve estimates. This uncertainty comes from many factors which may include changes in claims reporting and settlement patterns, changes in the regulatory and legal environments, uncertainty over inflation rates, and uncertainty for unknown items. The Company does not make specific provisions for these uncertainties, rather it considers them in establishing its loss reserve by reviewing historical patterns and trends and projecting these out to current loss reserves. The underlying factors and assumptions that serve as the basis for preparing the loss reserve estimate include paid and incurred loss development factors, expected average costs per claim, inflation trends, expected loss ratios, industry data, and other relevant information.

The Company also engages independent actuarial consultants to review the Company's loss reserves and to provide the annual actuarial opinions under statutory accounting principles as required by state regulation. The Company analyzes loss reserves quarterly primarily using the incurred loss, paid loss, average severity coupled with the claim count development methods, and the generalized linear model ("GLM") described below. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of insurance business or coverage within a line of insurance business. The Company may also evaluate qualitative factors such as known changes in laws or legal rulings that could affect claims handling or other external environmental factors or internal factors that could affect the settlement of claims. When establishing the loss reserve, the Company will generally analyze the results from all of the methods used rather than relying on a single method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

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The incurred loss method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of insurance business which have a long operating history.

• The paid loss method analyzes historical payment patterns to estimate the amount of losses yet to be paid.

The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The average severity method coupled with the claim count development method provide meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing loss reserves.

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The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The GLM determines an average severity for each percentile of claims that have been closed as a percentage of estimated ultimate claims. The average severities are applied to open claims to estimate the amount of losses yet to be paid. The GLM utilizes operational time, determined as a percentile of claims closed rather than a finite calendar period, which neutralizes the effect of changes in the timing of claims handling.

At June 30, 2017 and December 31, 2016, the Company recorded its point estimate of approximately \$1.33 billion and \$1.29 billion, respectively, in loss reserves, which include approximately \$558.7 million and \$534.8 million, respectively, of incurred but not reported loss reserves (“IBNR”). IBNR includes estimates, based upon past experience, of ultimate developed costs, which may differ from case estimates, unreported claims that occurred on or prior to June 30, 2017 and December 31, 2016, and estimated future payments for reopened claims. Management believes that the liability for loss reserves is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company evaluates its loss reserves quarterly. When management determines that the estimated ultimate claim cost requires a decrease for previously reported accident years, favorable development occurs and a reduction in losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, unfavorable development occurs and an increase in losses and loss adjustment expenses is reported in the current period. For the six months ended June 30, 2017, the Company reported unfavorable development of approximately \$14 million on the 2016 and prior accident years’ loss reserves, which at December 31, 2016 totaled approximately \$1.29 billion. The unfavorable development in 2017 was primarily attributable to higher than estimated California property losses.

For the six months ended June 30, 2017, the Company recorded catastrophe losses of approximately \$40 million, which were primarily attributable to severe rainstorms in California, as well as storms and tornadoes in Oklahoma and Texas. The Winter of 2017 was extremely wet in California, setting new precipitation records in parts of the state. For a further discussion of the Company’s reserving methods, see the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

Investments

The Company’s fixed maturity and equity securities are classified as “trading” and carried at fair value as required when applying the fair value option, with changes in fair value reflected in net realized investment gains or losses in the consolidated statements of operations. The majority of equity holdings, including non-redeemable preferred stocks, is actively traded on national exchanges or trading markets, and is valued at the last transaction price on the balance sheet dates.

Fair Value of Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, receivables, total return swaps, accounts payable, options sold, and secured and unsecured notes payable. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Due to their short-term maturity, the carrying values of receivables and accounts payable approximate their fair market values. All investments are carried on the consolidated balance sheets at fair value, as described in Note 3. Fair Value of Financial Instruments of the Notes to Consolidated Financial Statements. The Company’s financial instruments include securities issued by the U.S. government and its agencies, securities issued by states and municipal governments and agencies, certain corporate and other debt securities, equity securities, and exchange traded funds. 99.8% of the fair value of these financial instruments held at June 30, 2017 is based on

observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary by financial instrument. Observable market prices and pricing parameters of a financial instrument, or a related financial instrument, are used to derive a price without requiring significant judgment.

The Company may hold or acquire financial instruments that lack observable market prices or market parameters because they are less actively traded currently or in future periods. The fair value of such instruments is determined using techniques appropriate for each particular financial instrument. These techniques may involve some degree of judgment. The price transparency of the particular financial instrument will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including the type of financial instrument, whether

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it is a new financial instrument and not yet established in the marketplace, and the characteristics particular to the transaction. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, financial instruments that are thinly traded or not quoted will generally have diminished price transparency. Even in normally active markets, the price transparency for actively quoted instruments may be reduced during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market makers willing to purchase and sell a financial instrument provides a source of transparency for products that otherwise are not actively quoted.

Income Taxes

At June 30, 2017, the Company's deferred income taxes were in a net asset position mainly due to deferred tax assets generated by unearned premiums, alternative minimum tax credit carryforwards, expense accruals and loss reserve discounting. These deferred tax assets were substantially offset by deferred tax liabilities resulting from deferred acquisition costs and unrealized gains on securities held. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Management's recoverability assessment of the Company's deferred tax assets which are ordinary in character takes into consideration the Company's strong history of generating ordinary taxable income and a reasonable expectation that it will continue to generate ordinary taxable income in the future. Further, the Company has the capacity to recoup its ordinary deferred tax assets through tax loss carryback claims for taxes paid in prior years. Finally, the Company has various deferred tax liabilities that represent sources of future ordinary taxable income.

Management's recoverability assessment with regard to its capital deferred tax assets is based on estimates of anticipated capital gains, tax-planning strategies available to generate future taxable capital gains, and the Company's capacity to absorb capital losses carried back to prior years, each of which would contribute to the realization of deferred tax benefits. The Company has significant unrealized gains in its investment portfolio that could be realized through asset dispositions, at management's discretion. In addition, the Company expects to hold certain debt securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a portion of the unrealized loss positions at period-end, are fully realizable at maturity. Management believes its long-term time horizon for holding these securities allows it to avoid any forced sales prior to maturity. Further, the Company has the capability to generate additional realized capital gains by entering into sale-leaseback transactions using one or more of its appreciated real estate holdings. Finally, the Company has the capacity to recoup capital deferred tax assets through tax capital loss carryback claims for taxes paid within permitted carryback periods.

The Company has the capability to implement tax planning strategies as it has a steady history of generating positive cash flow from operations and believes that its cash flow needs can be met in future periods without the forced sale of its investments. This capability assists management in controlling the timing and amount of realized losses generated during future periods. By prudent utilization of some or all of these strategies, management has the intent and believes that it has the ability to generate capital gains and minimize tax losses in a manner sufficient to avoid losing the benefits of its deferred tax assets. Management will continue to assess the need for a valuation allowance on a quarterly basis. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

The Company's effective income tax rate can be affected by several factors. These generally include tax-exempt investment income, other non-deductible expenses, and periodically, non-routine tax items such as adjustments to unrecognized tax benefits related to tax uncertainties. The effective tax rate for the six months ended June 30, 2017 was 20.9%, compared to 20.1% for the same period in 2016. The increase in the effective tax rate was principally due to an increase of \$9.0 million in total pre-tax income for the first half of 2017 compared to total pre-tax income for the same period in 2016, while tax-exempt investment income, a component of pre-tax income, remained relatively consistent. The Company's effective tax rate for the six months ended June 30, 2017 was lower than the statutory tax rate primarily as a result of tax-exempt investment income earned.

Contingent Liabilities

The Company has known, and may have unknown, potential liabilities which include claims, assessments, lawsuits, or regulatory fines and penalties relating to the Company's business. The Company continually evaluates these potential liabilities and accrues for them and/or discloses them in the notes to the consolidated financial statements where required. The Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows. See "Regulatory and Legal Matters" above and Note 12. Contingencies of the Notes to Consolidated Financial Statements.

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Premiums

The Company's insurance premiums are recognized as income ratably over the term of the policies and in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the consolidated balance sheets and are computed monthly on a pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs, and maintenance costs partially offset by investment income to related unearned premiums. To the extent that any of the Company's lines of insurance business become unprofitable, a premium deficiency reserve may be required.

RESULTS OF OPERATIONS

Three Months Ended June 30, 2017 Compared to Three Months Ended June 30, 2016

Revenues

Net premiums earned and net premiums written during the three months ended June 30, 2017 increased 2.4% and 2.0%, respectively, from the corresponding period in 2016. The increase in net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile line of insurance business and growth in the number of homeowners policies written in California.

Net premiums earned, a GAAP measure, represents the portion of net premiums written that is recognized as revenue in the financial statements for the periods presented and earned on a pro-rata basis over the term of the policies. Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels.

The following is a reconciliation of total net premiums earned to net premiums written:

	Three Months Ended June 30, 2017 2016	
	(Amounts in thousands)	
Net premiums earned	\$797,666	\$779,321
Change in net unearned premium	(16)	2,347
Net premiums written	\$797,650	\$781,668

Expenses

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table presents the Insurance Companies' loss, expense, and combined ratios determined in accordance with GAAP:

	Three Months Ended June 30, 2017 2016	
Loss ratio	73.8%	76.4 %
Expense ratio	24.0%	25.4 %
Combined ratio ^(a)	97.8%	101.7%

(a) Combined ratio for the three months ended June 30, 2016 does not sum due to rounding.

Loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The Company's loss ratio was affected by unfavorable development of approximately \$10 million and \$22 million on prior accident years'

loss reserves during the second quarter of 2017 and 2016, respectively. The majority of the unfavorable development in the second quarter of 2017 was attributable to higher than estimated California property losses. The majority of the unfavorable development in the second quarter of 2016 was from the re-estimation of losses for California automobile liability coverages. In addition, the 2017 loss ratio was negatively impacted by approximately \$10 million of catastrophe losses, primarily due to storms and tornadoes in Oklahoma and Texas. The 2016 loss ratio was also negatively impacted by a total of \$11 million of catastrophe losses primarily due to severe storms in Texas. Excluding the effect of estimated prior accident years' loss development and catastrophe losses, the loss ratio was 71.3% and 72.1% for the second quarter of 2017 and 2016, respectively.

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Expense ratio is calculated by dividing the sum of policy acquisition costs and other operating expenses by net premiums earned. The 2017 expense ratio decreased compared to the 2016 expense ratio. Policy acquisition costs and advertising expenses for the second quarter of 2017 were lower compared to the same period in 2016, and net premiums earned for the second quarter of 2017 was slightly higher compared to the same period in 2016. Combined ratio is equal to loss ratio plus expense ratio and is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results, and a combined ratio over 100% generally reflects unprofitable underwriting results. Income tax expense was \$17.1 million and \$15.5 million for the three months ended June 30, 2017 and 2016, respectively. The \$1.7 million increase in income tax expense was primarily due to a \$4.4 million increase in total pre-tax income, while tax-exempt investment income, a component of total pre-tax income, remained relatively unchanged compared to the same period in 2016.

Investments

The following table presents the investment results of the Company:

	Three Months Ended June			
	30,			
	2017		2016	
	(Dollars in thousands)			
Average invested assets at cost ⁽¹⁾	\$3,561,717		\$3,350,328	
Net investment income ⁽²⁾				
Before income taxes	\$31,901		\$31,414	
After income taxes	\$27,991		\$27,555	
Average annual yield on investments ⁽²⁾				
Before income taxes	3.6	%	3.8	%
After income taxes	3.1	%	3.3	%
Net realized investment gains	\$21,156		\$45,381	

(1) Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each period.

Average annual yield on investments before and after income taxes decreased slightly, primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments. The higher net investment income before and after income taxes resulted from higher average invested assets.

The following tables present the components of net realized investment gains (losses) included in net income:

	Three Months Ended June 30, 2017		
	Gains (Losses) Recognized in Net Income		
	Sales	Changes in fair value	Total
	(Amounts in thousands)		
Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$(747)	\$25,622	\$24,875
Equity securities ⁽¹⁾⁽³⁾	2,253	(5,080)	(2,827)

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Short-term investments ⁽¹⁾	4	(267	)	(263	)	
Total return swaps	(1,315	)	(319	)	(1,634	)
Options sold	911	94		1,005		
Total	\$1,106	\$20,050		\$21,156		

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Three Months Ended June
30, 2016
Gains (Losses)
Recognized in Net Income
Changes
Sales in fair Total
value

(Amounts in thousands)

Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$923	\$28,871	\$29,794
Equity securities ⁽¹⁾⁽³⁾	2,897	8,666	11,563
Short-term investments ⁽¹⁾	503	(410)	) 93
Total return swaps	383	2,197	2,580
Options sold	1,379	(28)	) 1,351
Total	\$6,085	\$39,296	\$45,381

⁽¹⁾ The changes in fair value of the investment portfolio result from the application of the fair value option.

⁽²⁾ The increases in fair value of fixed maturity securities in the second quarters of 2017 and 2016 were primarily due to the overall improvement in the market conditions affecting fixed maturity securities.

⁽³⁾ The decreases in fair value of equity securities in the second quarter of 2017 compared to the increases in the second quarter of 2016 were primarily due to the relative decline in the equity markets in the second quarter of 2017 compared to an overall improvement in the equity markets in the second quarter of 2016.

Net Income

Three Months Ended
June 30,
2017 2016

(Amounts in thousands,
except per share data)

Net income	\$ 51,633	\$ 48,873
Basic average shares outstanding	55,311	55,254
Diluted average shares outstanding	55,323	55,322
Basic Per Share Data:		
Net income	\$ 0.93	\$ 0.88
Net realized investment gains, net of tax	\$ 0.25	\$ 0.53
Diluted Per Share Data:		
Net income	\$ 0.93	\$ 0.88
Net realized investment gains, net of tax	\$ 0.25	\$ 0.53

Six Months Ended June 30, 2017 Compared to Six Months Ended June 30, 2016

Revenues

Net premiums earned and net premiums written during the six months ended June 30, 2017 increased 2.7% and 1.9%, respectively, from the corresponding period in 2016. The increases in net premiums earned and net premiums written were primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile line of insurance business.

The following is a reconciliation of net premiums earned to net premiums written:

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	Six Months Ended June 30,	
	2017	2016
	(Amounts in thousands)	
Net premiums earned	\$1,587,436	\$1,546,406
Change in net unearned premiums	21,808	32,928
Net premiums written	\$1,609,244	\$1,579,334

Expenses

The following table presents the Insurance Companies' loss, expense, and combined ratios determined in accordance with GAAP:

	Six Months Ended June 30,	
	2017	2016
Loss ratio	75.3 %	76.9 %
Expense ratio	25.1 %	25.9 %
Combined ratio	100.4 %	102.8 %

The Company's loss ratio was affected by unfavorable development of approximately \$14 million and unfavorable development of approximately \$62 million on prior accident years' loss reserves during the first half of 2017 and 2016, respectively. The majority of the unfavorable development in the first half of 2017 resulted from higher than estimated California property losses, while the unfavorable development in the first half of 2016 was largely attributable to the re-estimation of losses for California and Florida automobile liability coverages. The 2017 loss ratio was also negatively impacted by a total of \$40 million of catastrophe losses, primarily due to severe rainstorms in California, as well as storms and tornadoes in Oklahoma and Texas. The Winter of 2017 was extremely wet in California, setting new precipitation records in parts of the state. The 2016 loss ratio was also negatively impacted by a total of \$19 million of catastrophe losses primarily due to severe winter storms in Texas and in northern California. Excluding the effect of estimated prior accident years' loss development and catastrophe losses, the loss ratio was 71.9% and 71.7% for the first half of 2017 and 2016, respectively.

The 2017 expense ratio decreased compared to the 2016 expense ratio due to lower advertising expenses for the first half of 2017 compared to the same period in 2016, and higher net premiums earned for the first half of 2017 compared to the same period in 2016.

Income tax expense was \$20.7 million and \$18.2 million for the six months ended June 30, 2017 and 2016, respectively. The \$2.6 million increase in income tax expense was primarily due to a \$9.0 million increase in total pre-tax income, while tax-exempt investment income, a component of total pre-tax income, remained relatively unchanged compared to the same period in 2016.

Investments

The following table presents the investment results of the Company:

	Six Months Ended June 30,	
	2017	2016
	(Dollars in thousands)	
Average invested assets at cost ⁽¹⁾	\$3,532,454	\$3,339,312
Net investment income ⁽²⁾		
Before income taxes	\$63,070	\$61,069
After income taxes	\$55,310	\$53,588
Average annual yield on investments ⁽²⁾		
Before income taxes	3.6	% 3.7 %

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After income taxes	3.1	%	3.2	%
Net realized investment gains	\$45,616		\$70,438	

Fixed maturities and short-term bonds at amortized cost; and equities and other short-term investments at cost.

(1) Average invested assets at cost are based on the monthly amortized cost of the invested assets for each respective period.

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- Average annual yield on investments before and after income taxes decreased slightly, primarily due to the
- (2) maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments. The higher net investment income before and after income taxes resulted from higher average invested assets.

The following tables present the components of net realized investment gains (losses) included in net income:

Six Months Ended June 30,
2017
Gains (Losses) Recognized in
Net Income

Sales	Changes in fair value	Total
-------	-----------------------------	-------

(Amounts in thousands)

Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$(1,190)	\$35,909	\$34,719
Equity securities ⁽¹⁾⁽³⁾	6,019	6,462	12,481
Short-term investments ⁽¹⁾	9	(240)	(231)
Total return swaps	(1,027)	(1,627)	(2,654)
Options sold	1,263	38	1,301
Total	\$5,074	\$40,542	\$45,616

Six Months Ended June 30,
2016
Gains (Losses) Recognized in
Net Income

Sales	Changes in fair value	Total
-------	-----------------------------	-------

(Amounts in thousands)

Net realized investment gains (losses)			
Fixed maturity securities ⁽¹⁾⁽²⁾	\$1,633	\$40,434	\$42,067
Equity securities ⁽¹⁾⁽³⁾	7,109	15,573	22,682
Short-term investments ⁽¹⁾	—	(349)	(349)
Total return swap	(181)	3,925	3,744
Options sold	2,334	(40)	2,294
Total	\$10,895	\$59,543	\$70,438

(1) The changes in fair value of the investment portfolio result from the application of the fair value option.

(2) The increases in fair value of fixed maturity securities in the first half of 2017 and 2016 were primarily due to the overall improvement in the market conditions affecting fixed maturity securities.

(3) The increases in fair value of equity securities in the first half of 2017 and 2016 were primarily due to the relative improvement in the equity markets.

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Net Income

Six Months Ended June
30,
2017 2016

(Amounts in thousands,
except per share data)

Net income	\$ 78,613	\$ 72,196
Basic average shares outstanding	55,304	55,227
Diluted average shares outstanding	55,318	55,294
Basic Per Share Data:		
Net income	\$ 1.42	\$ 1.31
Net realized investment gains (losses), net of tax	\$ 0.53	\$ 0.83
Diluted Per Share Data:		
Net income	\$ 1.42	\$ 1.31
Net realized investment gains (losses), net of tax	0.53	0.83

LIQUIDITY AND CAPITAL RESOURCES

A. Cash Flows

The Company has generated positive cash flow from operations since the public offering of its common stock in November 1985. The Company does not attempt to match the duration and timing of asset maturities with those of liabilities; rather, it manages its portfolio with a view towards maximizing total return with an emphasis on after-tax income. With combined cash and short-term investments of \$541.5 million at June 30, 2017 as well as \$50 million of credit available on a \$50 million revolving credit facility, the Company believes its cash flow from operations is adequate to satisfy its liquidity requirements without the forced sale of investments. Investment maturities are also available to meet the Company's liquidity needs. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs or for future business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

Net cash provided by operating activities for the six months ended June 30, 2017 was \$174.7 million, an increase of \$69.0 million compared to the corresponding period in 2016. The increase was primarily due to a decrease in operating expenses paid and an increase in premium collections, partially offset by higher paid losses and loss adjustment expenses. The Company utilized the cash provided by operating activities during the first half of 2017 primarily for the payment of dividends to its shareholders and net purchases of investment securities.

The following table presents the estimated fair value of fixed maturity securities at June 30, 2017 by contractual maturity in the next five years:

	Fixed Maturity Securities (Amounts in thousands)
Due in one year or less	\$ 303,014
Due after one year through two years	171,208
Due after two years through three years	136,602

Due after three years through four years	108,334
Due after four years through five years	61,607
Total due within five years	\$ 780,765

B. Reinsurance

For California homeowners policies, the Company has reduced its catastrophe exposure from earthquakes by placing earthquake risks directly with the California Earthquake Authority ("CEA"). However, the Company continues to have catastrophe exposure to fires following an earthquake.

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The Company is party to a Catastrophe Reinsurance Treaty ("Treaty") covering a wide range of perils that has been renewed through June 30, 2018. The Treaty for the 12 months ending June 30, 2018 provides \$205 million of coverage on a per occurrence basis after covered catastrophe losses exceed the \$10 million Company retention limit. The first \$190 million of losses above the Company's \$10 million retention are covered 100% by the reinsurers. Losses above \$200 million are shared pro-rata with 5% coverage by the reinsurers and 95% retention by the Company, up to \$15 million total coverage provided by the reinsurers. The Treaty specifically excludes coverage for any Florida business and for California earthquake losses on fixed property policies, such as homeowners, but does cover losses from fires following an earthquake. The annual premium for the Treaty is approximately \$19 million and \$6 million for the 12 months ending June 30, 2018 and 2017, respectively. The increase in the annual premium reflects the increased coverage. The Treaty for the 12 months ended June 30, 2017 provided \$115 million of coverage on a per occurrence basis after covered catastrophe losses exceeded a \$100 million Company retention.

The Company carries a commercial umbrella reinsurance treaty and seeks facultative arrangements for large property risks. In addition, the Company has other reinsurance in force that is not material to the consolidated financial statements. If any reinsurers are unable to perform their obligations under a reinsurance treaty, the Company will be required, as primary insurer, to discharge all obligations to its policyholders in their entirety.

C. Invested Assets

Portfolio Composition

An important component of the Company's financial results is the return on its investment portfolio. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well-diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company continues to believe that this strategy enables the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and consistent asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

The following table presents the composition of the total investment portfolio of the Company at June 30, 2017:

	Cost ⁽¹⁾	Fair Value
(Amounts in thousands)		
Fixed maturity securities:		
U.S. government bonds and agencies	\$11,751	\$11,735
Municipal securities	2,551,433	2,603,646
Mortgage-backed securities	32,675	33,551
Corporate securities	164,937	165,880
Collateralized loan obligations	82,594	83,465
Other asset-backed securities	53,642	53,807
	2,897,032	2,952,084
Equity securities:		
Common stock	356,905	392,514
Non-redeemable preferred stock	25,275	25,751
Private equity funds	12,831	8,764
	395,011	427,029

Short-term investments	280,304	280,045
Total investments	\$3,572,347	\$3,659,158

⁽¹⁾ Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost.

At June 30, 2017, 70.9% of the Company's total investment portfolio at fair value and 87.9% of its total fixed maturity securities at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of non-redeemable preferred

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stocks, dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and private equity funds. At June 30, 2017, 83.6% of short-term investments consisted of highly rated short-duration securities redeemable on a daily or weekly basis. The Company does not have any direct equity investment in sub-prime lenders.

Fixed Maturity Securities and Short-Term Investments

Fixed maturity securities include debt securities, which are mostly long-term bonds and other debt with maturities of at least one year from purchase, and which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Short-term instruments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

A primary exposure for the fixed maturity securities is interest rate risk. The longer the duration, the more sensitive the asset is to market interest rate fluctuations. As assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy has resulted in a portfolio with a moderate duration. The Company's portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity securities purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The holdings, which are heavily weighted with high coupon issues, are expected to be called prior to maturity. Modified duration measures the length of time it takes, on average, to receive the present value of all the cash flows produced by a bond, including reinvestment of interest. As it measures four factors (maturity, coupon rate, yield and call terms) which determine sensitivity to changes in interest rates, modified duration is considered a better indicator of price volatility than simple maturity alone.

The following table presents the maturity and duration of the Company's fixed maturity securities portfolio:
June 30, 2017 December 31, 2016

	(in years)	
Fixed Maturity Securities		
Nominal average maturities:		
excluding short-term instruments	12.8	11.9
including short-term instruments	11.7	10.5
Call-adjusted average maturities:		
excluding short-term instruments	4.9	4.5
including short-term instruments	4.5	4.0
Modified durations reflecting anticipated early calls:		
excluding short-term instruments	4.4	4.1
including short-term instruments	4.0	3.7
Collateralized Mortgage Obligations Modified Durations	4.2	3.7
Short-term Instruments	—	—

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of A+, at fair value, at June 30, 2017, consistent with the average rating at December 31, 2016. The Company's municipal bond holdings of which 99.6% were tax exempt, represented 87.9% of its fixed maturity securities portfolio at June 30, 2017, at fair value, and are broadly diversified geographically. See Item 3. Quantitative and Qualitative Disclosures About Market Risks for a breakdown of municipal bond holdings by state.

To calculate the weighted-average credit quality ratings disclosed throughout this Quarterly Report on Form 10-Q, individual securities were weighted based on fair value and a credit quality numeric score that was assigned to each security's average of ratings assigned by nationally recognized securities rating organizations.

Taxable holdings consist principally of investment grade issues. At June 30, 2017, fixed maturity securities holdings rated below investment grade and non-rated bonds totaled \$67.3 million and \$98.0 million, respectively, at fair value, and represented 2.3% and 3.3%, respectively, of total fixed maturity securities. The majority of non-rated issues are a result of municipalities pre-funding and collateralizing those issues with U.S. government securities with an implicit AAA equivalent credit risk. At

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December 31, 2016, fixed maturity securities holdings rated below investment grade and non-rated bonds totaled \$51.6 million and \$86.6 million, respectively, at fair value, and represented 1.8% and 3.1%, respectively, of total fixed maturity securities.

Credit ratings for the Company's fixed maturity securities portfolio were stable during the six months ended June 30, 2017, with 89.0% of fixed maturity securities at fair value experiencing no change in their overall rating. 3.8% and 7.2% of fixed maturity securities at fair value experienced upgrades and downgrades, respectively, during the first half of 2017. The downgrades were slight and still within the investment grade portfolio during the six months ended June 30, 2017.

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The following table presents the credit quality ratings of the Company's fixed maturity securities portfolio by security type at fair value:

Security Type	June 30, 2017 (Dollars in thousands)						Total Fair Value ⁽¹⁾	
	AAA ⁽¹⁾	AA ⁽¹⁾	A ⁽¹⁾	BBB ⁽¹⁾	Non-Rated/Other ⁽¹⁾			
U.S. government bonds and agencies:								
Treasuries	\$ 11,735	\$—	\$—	\$—	\$—		\$ 11,735	
Government agency	—	—	—	—	—		—	
Total	11,735	—	—	—	—		11,735	
	100.0	% —	% —	% —	% —	%	100.0	%
Municipal securities:								
Insured	40,329	217,135	306,850	28,669	18,179		611,162	
Uninsured	51,129	690,891	982,712	180,360	87,392		1,992,484	
Total	91,458	908,026	1,289,562	209,029	105,571		2,603,646	
	3.5	% 34.9	% 49.4	% 8.1	% 4.1	%	100.0	%
Mortgage-backed securities:								
Commercial	—	10,383	10,376	4,001	—		24,760	
Agencies	2,893	—	—	—	—		2,893	
Non-agencies:								
Prime	—	—	377	83	1,222		1,682	
Alt-A	—	—	—	1,069	3,147		4,216	
Total	2,893	10,383	10,753	5,153	4,369		33,551	
	8.7	% 30.9	% 32.0	% 15.4	% 13.0	%	100.0	%
Corporate securities:								
Basic materials	—	—	—	6,382	2,613		8,995	
Communications	—	—	163	5,760	—		5,923	
Consumer, cyclical	—	—	1,392	11,183	4,568		17,143	
Consumer, non-cyclical	—	—	316	7,789	—		8,105	
Energy	—	—	6,354	21,483	30,090		57,927	
Financial	—	848	18,553	27,914	—		47,315	
Industrial	—	—	166	4,381	—		4,547	
Technology	—	—	—	—	8,799		8,799	
Utilities	—	—	6,412	151	563		7,126	
Total	—	848	33,356	85,043	46,633		165,880	
	—	% 0.5	% 20.1	% 51.3	% 28.1	%	100.0	%
Collateralized loan obligations:								
Corporate	1,306	1,489	71,670	—	9,000		83,465	
Total	1,306	1,489	71,670	—	9,000		83,465	
	1.5	% 1.8	% 85.9	% —	% 10.8	%	100.0	%
Other asset-backed securities	11,000	9,900	17,622	15,285	—		53,807	
	20.4	% 18.4	% 32.8	% 28.4	% —	%	100.0	%
Total	\$ 118,392	\$ 930,646	\$ 1,422,963	\$ 314,510	\$ 165,573		\$ 2,952,084	
	4.0	% 31.5	% 48.2	% 10.7	% 5.6	%	100.0	%

⁽¹⁾ Intermediate ratings are included at each level (e.g., AA includes AA+, AA and AA-).

U.S. Government Bonds and Agencies

The Company had \$14.6 million, or 0.5% of its fixed maturity securities portfolio, at fair value, in U.S. government bonds and agencies and mortgage-backed securities (Agencies) at June 30, 2017. In February 2016, Moody's and Fitch affirmed their

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Aaa and AAA ratings, respectively, for U.S. government-issued debt, although a significant increase in government deficits and debt could lead to a downgrade. The Company understands that market participants continue to use rates of return on U.S. government debt as a risk-free rate and have continued to invest in U.S. Treasury securities.

Municipal Securities

The Company had \$2.60 billion at fair value (\$2.55 billion at amortized cost) in municipal bonds at June 30, 2017, of which \$611.2 million are insured. The underlying ratings for insured municipal bonds have been factored into the average rating of the securities by the rating agencies with no significant disparity between the absolute bond ratings and the underlying credit ratings as of June 30, 2017.

62.2% of the insured municipal securities, most of which are investment grade, are insured by bond insurers that provide credit enhancement and ratings reflecting the credit of the underlying issuers. At June 30, 2017, the average rating of the Company's insured investment grade municipal securities was A+, with an underlying rating of A+. The remaining 37.8% of insured municipal securities are non-rated or below investment grade, and are insured by bond insurers that the Company believes do not provide credit enhancement.

The Company considers the strength of the underlying credit as a buffer against potential market value declines which may result from future rating downgrades of the bond insurers. In addition, the Company has a long-term time horizon for its municipal bond holdings which generally allows it to recover the full principal amounts upon maturity and avoid forced sales prior to maturity of bonds that have declined in market value due to the bond insurers' rating downgrades. Based on the uncertainty surrounding the financial condition of these insurers, it is possible that there will be additional downgrades to below investment grade ratings by the rating agencies in the future, and such downgrades could impact the estimated fair value of municipal bonds.

Mortgage-Backed Securities

At June 30, 2017 and December 31, 2016, respectively, the mortgage-backed securities portfolio of \$33.6 million and \$39.8 million at fair value (\$32.7 million and \$39.1 million at amortized cost) was categorized as loans to "prime" residential and commercial real estate borrowers except for \$4.2 million and \$4.5 million at fair value (\$4.2 million and \$4.5 million at amortized cost) of Alt-A mortgages. Alt-A mortgage-backed securities are at fixed or variable rates and include certain securities that are collateralized by residential mortgage loans issued to borrowers with credit profiles stronger than those of sub-prime borrowers, but do not qualify for prime financing terms due to high loan-to-value ratios or limited supporting documentation. The Company had holdings of \$24.8 million and \$30.0 million at fair value (\$24.2 million and \$29.6 million at amortized cost) in commercial mortgage-backed securities at June 30, 2017 and December 31, 2016, respectively.

The weighted-average rating of the Company's Alt-A mortgage-backed securities at June 30, 2017 and December 31, 2016 was B-. The weighted-average rating of the entire mortgage-backed securities portfolio was A at June 30, 2017 and December 31, 2016.

Corporate Securities

Corporate securities included in fixed maturity securities are as follows:

	June 30, 2017	December 31, 2016
	(Amounts in thousands)	
Corporate securities at fair value	\$ 165,880	\$ 189,688
Duration	2.4 years	2.4 years
Weighted-average rating	BBB-	BBB-

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Collateralized Loan Obligations

Collateralized loan obligations included in fixed maturity securities are as follows:

	June 30, 2017	December 31, 2016
	(Amounts in thousands)	
Collateralized loan obligations at fair value	\$83,465	\$ 86,525
Percentage of total investment portfolio	2.3 %	2.4 %
Duration	5.3 years	4.4 years
Weighted-average rating	A	A
Equity Securities		

Equity holdings of \$427.0 million consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and private equity funds. The net gains due to changes in fair value of the Company's equity securities portfolio during the six months ended June 30, 2017 were \$6.5 million. The primary cause of the increase in the value of the Company's equity securities was the overall improvement in the equity markets during the six months ended June 30, 2017.

The Company's common stock allocation is intended to enhance the return of and provide diversification for the total portfolio. At June 30, 2017, 11.7% of the total investment portfolio at fair value was held in equity securities, compared to 10.1% at December 31, 2016.

D. Debt

On March 8, 2017, the Company paid off the total outstanding balance of \$320 million under the existing loan and credit facility agreements with the proceeds from its public offering of \$375 million of senior notes, and terminated the agreements.

On March 8, 2017, the Company completed a public debt offering issuing \$375 million of senior notes. The notes are unsecured, senior obligations of the Company with a 4.40% annual coupon payable on March 15 and September 15 of each year commencing September 15, 2017. The notes mature on March 15, 2027. The Company used the proceeds from the notes to pay off amounts outstanding under the existing loan and credit facilities and for general corporate purposes. The Company incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective annualized interest rate including debt issuance costs of approximately 4.45%.

On March 29, 2017, the Company entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 17.5% at June 30, 2017, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of July 27, 2017, there have been no borrowings under this facility.

The Company was in compliance with all of its financial covenants pertaining to minimum statutory surplus, debt to total capital ratio, and risk based capital ratio under the unsecured credit facility at June 30, 2017.

For additional information on debt, see Note 11. Notes Payable of the Notes to Consolidated Financial Statements.

E. Regulatory Capital Requirements

Among other considerations, industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.0 to 1. Based on the combined surplus of all the Insurance Companies of \$1.58 billion at June 30, 2017, and net premiums written of \$3.2 billion for the twelve months ended on that date, the ratio of net premiums written to surplus was 2.01 to 1 at June 30, 2017.

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Item 3. Quantitative and Qualitative Disclosures About Market Risks

The Company is subject to various market risk exposures primarily due to its investing and borrowing activities. Primary market risk exposures are changes in interest rates, equity prices, and credit risk. Adverse changes to these rates and prices may occur due to changes in the liquidity of a market, or to changes in market perceptions of creditworthiness and risk tolerance. The following disclosure reflects estimates of future performance and economic conditions. Actual results may differ.

Overview

The Company's investment policies define the overall framework for managing market and investment risks, including accountability and controls over risk management activities, and specify the investment limits and strategies that are appropriate given the liquidity, surplus, product profile, and regulatory requirements of the subsidiaries. Executive oversight of investment activities is conducted primarily through the Company's investment committee. The Company's investment committee focuses on strategies to enhance after-tax yields, mitigate market risks, and optimize capital to improve profitability and returns.

The Company manages exposures to market risk through the use of asset allocation, duration, and credit ratings. Asset allocation limits place restrictions on the total funds that may be invested within an asset class. Duration limits on the fixed maturities portfolio place restrictions on the amount of interest rate risk that may be taken. Comprehensive day-to-day management of market risk within defined tolerance ranges occurs as portfolio managers buy and sell within their respective markets based upon the acceptable boundaries established by investment policies.

Credit Risk

Credit risk results from uncertainty in a counterparty's ability to meet its obligations. Credit risk is managed by maintaining a high credit quality fixed maturities portfolio. As of June 30, 2017, the estimated weighted-average credit quality rating of the fixed maturities portfolio was A+, at fair value, consistent with the average rating at December 31, 2016.

The following table presents municipal bond holdings by state in descending order of holdings at fair value at June 30, 2017:

States	Fair Value	Average Rating
	(Amounts in thousands)	
Texas	\$ 428,483	AA-
California	253,623	A+
Florida	204,923	A+
Illinois	147,224	A-
Washington	123,362	AA-
Other states	1,446,031	A+
Total	\$ 2,603,646	

The portfolio is broadly diversified among the states and the largest holdings are in populous states such as Texas and California. These holdings are further diversified primarily among cities, counties, schools, public works, hospitals, and state general obligations. The Company seeks to minimize overall credit risk and ensure diversification by limiting exposure to any particular issuer.

Taxable fixed maturity securities represented 12.1% of the Company's total fixed maturity securities portfolio at June 30, 2017. 4.1% of the Company's taxable fixed maturity securities were comprised of U.S. government bonds and agencies and mortgage-backed securities (Agencies), which were rated AAA at June 30, 2017. 14.2% of the Company's taxable fixed maturity securities, representing 1.7% of its total fixed maturity securities portfolio, were rated below investment grade. Below investment grade issues are considered "watch list" items by the Company, and their status is evaluated within the context of the Company's overall portfolio and its investment policy on an

aggregate risk management basis, as well as their ability to recover their investment on an individual issue basis.

Equity Price Risk

Equity price risk is the risk that the Company will incur losses due to adverse changes in the equity markets.

At June 30, 2017, the Company's primary objective for common equity investments was current income. The fair value of the equity investments consisted of \$392.5 million in common stocks, \$25.8 million in non-redeemable preferred stocks, and \$8.8

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million in private equity funds. Common stock equity assets are typically valued for future economic prospects as perceived by the market.

Common stocks represented 10.7% of total investments at fair value at June 30, 2017. Beta is a measure of a security's systematic (non-diversifiable) risk, which is measured by the percentage change in an individual security's return for a 1% change in the return of the market.

Based on hypothetical reductions in the overall value of the stock market, the following table illustrates estimated reductions in the overall value of the Company's common stock portfolio at June 30, 2017 and December 31, 2016:

	June 30, 2017	December 31, 2016
	(Amounts in thousands, except average Beta)	
Average Beta	0.88	0.83
Hypothetical reduction in the overall value of the stock market of 25%	\$86,353	\$70,410
Hypothetical reduction in the overall value of the stock market of 50%	\$172,706	\$140,820

Interest Rate Risk

Interest rate risk is the risk that the Company will incur a loss due to adverse changes in interest rates relative to the interest rate characteristics of interest bearing assets and liabilities. The Company faces interest rate risk, as it invests substantial funds in interest sensitive assets and issues interest sensitive liabilities. Interest rate risk includes risks related to changes in U.S. Treasury yields and other key benchmarks, as well as changes in interest rates resulting from widening credit spreads and credit exposure to collateralized securities.

The fair value of the fixed maturity securities portfolio at June 30, 2017, which represented 80.7% of total investments at fair value, is subject to interest rate risk. The change in market interest rates is inversely related to the change in the fair value of the fixed maturity securities portfolio. A common measure of the interest sensitivity of fixed maturity securities is modified duration, a calculation that utilizes maturity, coupon rate, yield and call terms to calculate an average age of the expected cash flows generated by such assets. The longer the duration, the more sensitive the asset is to market interest rate fluctuations.

The Company has historically invested in fixed maturity securities investments with a goal of maximizing after-tax yields and holding assets to the maturity or call date. Since assets with longer maturities tend to produce higher current yields, the Company's historical investment philosophy resulted in a portfolio with a moderate duration. Bond investments made by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The modified durations of the overall bond portfolio reflecting anticipated early calls were 4.0 years and 3.7 years at June 30, 2017 and December 31, 2016, respectively.

Given a hypothetical increase of 100 or 200 basis points in interest rates, the Company estimates that the fair value of its bond portfolio at June 30, 2017 would decrease by \$126.5 million or \$252.9 million, respectively. Conversely, if interest rates were to decrease, the fair value of the Company's bond portfolio would rise, and it may cause a higher number of the Company's bonds to be called away. The proceeds from the called bonds would likely be reinvested at lower yields which would result in lower overall investment income for the Company.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, and that such

information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief

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Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this Quarterly Report on Form 10-Q. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company's process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2016. See also "Overview-C. Regulatory and Legal Matters" in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

There are no environmental proceedings arising under federal, state, or local laws or regulations to be discussed.

Item 1A. Risk Factors

The Company's business, results of operations, and financial condition are subject to various risks. These risks are described elsewhere in this Quarterly Report on Form 10-Q and in the Company's other filings with the United States Securities and Exchange Commission, including the Company's Annual Report on Form 10-K for the year ended December 31, 2016. The risk factors identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2016 have not changed in any material respect.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosure

Not applicable.

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Item 5. Other Information

None.

Item 6. Exhibits

- 15.1 Report of Independent Registered Public Accounting Firm.
- 15.2 Awareness Letter of Independent Registered Public Accounting Firm.
- 31.1 Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Registrant's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.
- 32.2 Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.
- 101.INS XBRL Instance Document.
- 101.SCH XBRL Taxonomy Extension Schema Document.
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document.
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document.
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MERCURY GENERAL CORPORATION

Date: August 1, 2017 By: /s/ Gabriel Tirador
Gabriel Tirador
President and Chief Executive Officer

Date: August 1, 2017 By: /s/ Theodore R. Stalick
Theodore R. Stalick
Senior Vice President and Chief Financial Officer