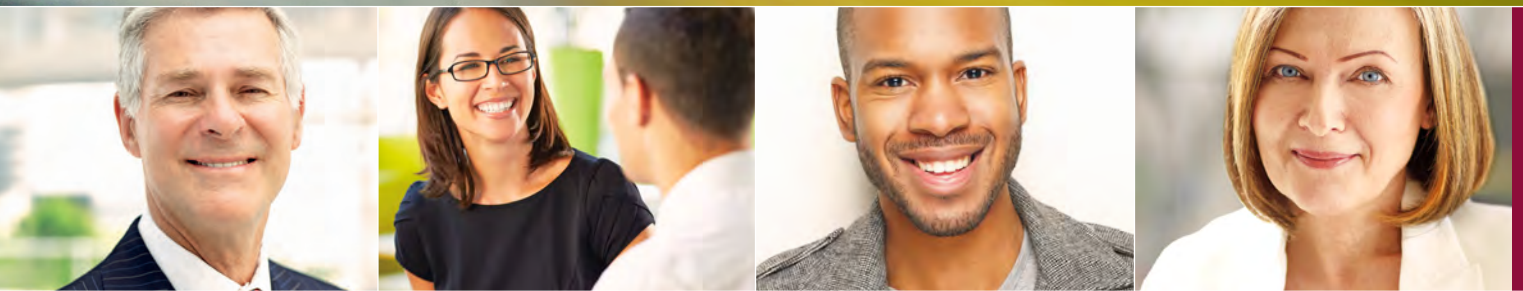




Moving Forward Together



2013 Annual Report



A company is only as strong as its people. And, we couldn't be more proud of ours. Over the last half century, Mercury has been home to the best and brightest the industry has to offer. The efforts and ingenuity of our team have fueled Mercury's long tenure of success. Today, we have approximately 4,500 reasons to be thankful. As a token of appreciation, this year's annual report is dedicated to the professional men and women throughout all areas of our organization who, every day, in ways big and small, keep this company moving forward.

Where does Mercury go from here? We move forward together...





Mercury Employees are...

...Our Driving Force

A shared commitment to excellence—this is what drives the thousands of dedicated men and women that make up the Mercury workforce. By implementing programs like our service excellence initiative, we have committed ourselves to ensuring customer satisfaction, resulting in faster response time, fair claim settlements, personal attention and lasting customer relationships. This kind of success requires teamwork at every level of our organization. The Mercury brand of excellence means going the extra mile and raising the bar a little higher, every day.

...Our Engine of Growth

Over the last 50 plus years, Mercury has grown from a small local company of six employees and 90 agents to more than 4,500 employees and 8,300 agents today. With professionalism and pride, they serve the needs of more than 1.7 million policyholders nationwide. As the company has grown and expanded into other lines of business, including home and business coverage, our employees have been there every step of the way, rising to meet every challenge. Rain or shine, day or night, they answer the call. From the front lines to the back office, our ranks are filled with experienced, motivated people who continue to fuel our growth.

...Our Ignition for Distinction

Mercury has been named one of “Forbes Most Trustworthy Companies” several times in the past seven years. We view this as a direct reflection of the caliber and integrity of our people. After all, ours is a business built on trust. Over the last half-century, we have earned more than accolades. We have earned the trust of our customers, partners and shareholders. With every transaction, we have the assurance of knowing that this trust is in very capable hands. As a testament to our ongoing commitment to unsurpassed customer service, Mercury’s JD Power score has risen more than any other automobile insurance company over the past five years.

...Our Pathway Forward

At Mercury, we keep our eye on the road ahead. Thanks to the innovative and progressive thinking of countless individuals throughout our organization, Mercury has remained competitive by keeping pace with emerging industry trends in a rapidly changing world. In recent years, we have introduced improved pricing strategies, launched new commercial and private passenger auto products in selected markets, made investments in technology, increased relationships with qualified agents and, introduced a new program enabling customers to purchase a policy online. We will continue to explore various new pathways forward as our industry evolves and we, as a company, move forward—full speed ahead.

...the key to Mercury’s success!

Company Highlights



8,300

With a network of approximately 8,300 local independent agents, Mercury offers a uniquely personalized approach, with customized policies to fit each individual need.

With approximately 1.7 million policyholders nationwide, representing approximately \$2.7 billion in premiums written for the year ended December 31, 2013, Mercury is one of the most trusted insurance companies in the nation.

1.7

96%

Mercury has earned solid customer loyalty by providing quality plans at affordable prices, with 96% of California private passenger automobile customers choosing to renew.

Marking its 51st year in business this year, Mercury has proven its staying power, with a sterling reputation built on financial strength, consistent performance, quality products and an unwavering commitment to customer satisfaction.

51st



Servicing the needs of thousands of policyholders, Mercury is open for business 24 hours a day, seven days a week, 365 days of the year that's 8,760 hours a year.

8,760

1985

The year Mercury began paying a quarterly shareholder dividend. The company has increased its dividend every year since.

California is Mercury's largest market and where it all began more than half a century ago. Today, Mercury is the 5th largest writer of private passenger automobile insurance in the state.

5th

4,500

The number one reason for Mercury's enduring success over the last 51 years? The 4,500 employees who make it all possible.

Letter to Shareholders

Our 2013 operating earnings were \$2.18 cents per share compared to \$1.34 cents per share in 2012, a 62.7% improvement. Premiums written for the year increased by 2.9%.

Over the past few years our operating results have not provided the returns we expect to deliver and have historically provided to our shareholders. Although our 2013 operating results improved dramatically over 2012, we still have much work to do to achieve an acceptable return on shareholders' equity. Many factors have made it difficult to achieve higher returns these past few years, including our difficulty in obtaining approval of rate increases in California, our largest market, a lower interest rate environment and our operating results outside of California. However, 2013 was a step in the right direction.

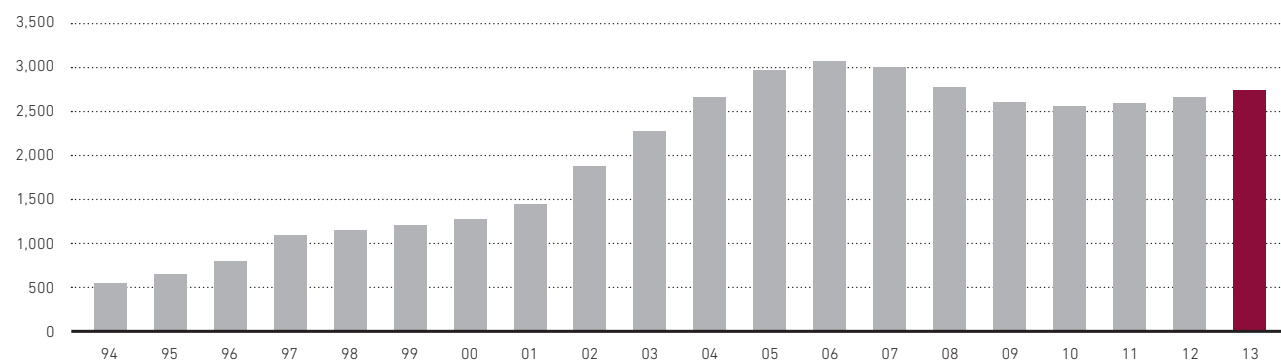
Our 2013 operating earnings were \$2.18 cents per share compared to \$1.34 cents per share in 2012, a 62.7% improvement. Premiums written for the year increased by 2.9%. The improvement in our

operating earnings was largely the result of improved profitability in states outside of California due to rate, underwriting and other operational actions taken over the past few years, fewer catastrophe losses, and less adverse development on prior period loss reserves. For the full year, we recorded approximately \$3 million of adverse reserve development compared to approximately \$42 million in 2012.

Difficulties in obtaining regulatory approval for rate increases in California have had a negative impact on our results. Consequently, for the past two years we posted a combined ratio over 100% in our California private passenger automobile line of business. However, we recently have made significant progress in obtaining rate approvals in California. In July 2013, we implemented a 6.9% rate increase on our California non-standard private passenger automobile business

Premiums Written

(in millions)

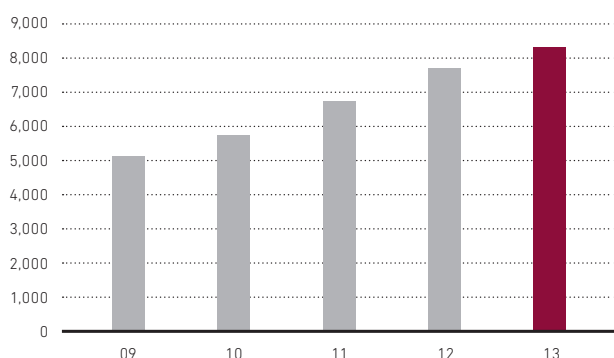


which represents 22% of our total California private passenger automobile business. In January 2014 we implemented a 6.0% rate increase on our California preferred private passenger automobile business, which represents 78% of our California private passenger automobile business. In addition, we implemented an 8.26% rate increase on our California homeowners business in January 2014 and recently obtained approvals for a 6.7% rate increase on California business automobile policies and an 11% rate increase on California mechanical breakdown policies. We currently have one rate filing pending approval with the Department of Insurance for an additional rate increase of 6.9% on our California non-standard private passenger automobile business that was filed in December 2013. We expect our results in California to improve in 2014 as these rate increases begin to earn in.

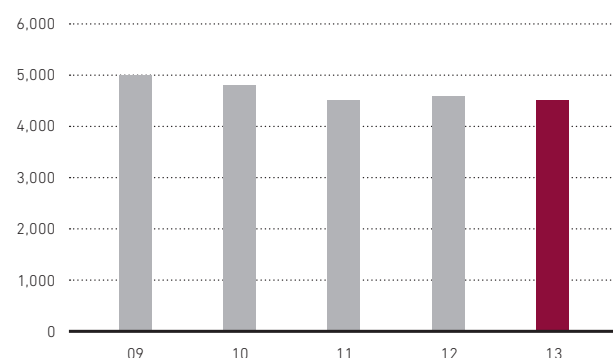
One of our top priorities in the past several years has been to improve our results outside of California. For the full year, excluding catastrophe losses, our operations outside of California posted a combined ratio under 100%. Although our margins outside of California have improved dramatically over the past few years, premiums written outside of California have declined as rate increases affected our retention levels and impacted our ability to generate new business.

To improve our cost structure outside of California, last year we consolidated our claims and underwriting operations located outside of California into hub locations in Florida, New Jersey and Texas. Additional expense reduction measures were taken or are planned, including a new commission structure that compensates our agents based on the individual relationship the agent has with the Company. These

Number of Agents



Number of Employees



Letter to Shareholders

changes to our cost structure coupled with our review of loss indications allowed us to reduce private passenger auto rates in five of our markets in the first quarter of 2014. The rate reductions had an immediate positive impact on new business sales in all of these markets. Although we expect our new business sales outside of California to improve as a result of our rate reductions, we don't expect premiums written to grow in the near term as it will take some time for new business sales to impact premiums written and offset the lower average premiums from the rate reductions.

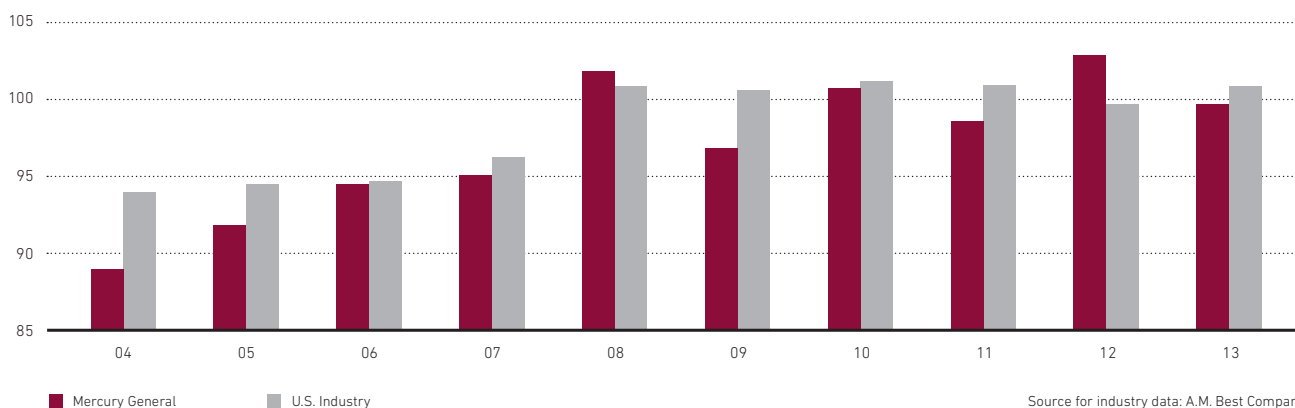
Our historical targeted combined ratio for private passenger auto is 95% and we generally price our private passenger auto product to that target. However, in states outside of California we are pricing our product to expense targets that we have not yet achieved, but expect to achieve over the next several years. This pricing strategy will allow us to be more competitive than we otherwise would be, but it means that our margins will be lower than our long term target for the next few years.

We plan to implement various initiatives to help grow our business and improve our profitability. Our priorities for 2014 include:

- Continuing to refine our pricing segmentation and monitoring our overall rate adequacy;
- Implementing various operational strategies to reduce our loss adjustment expenses;
- Implementing a new commission structure based on the agents' relationship with the Company;
- Focusing on increasing our agents quote volume;
- Introducing a paperless solution for underwriting and claims for various business lines;
- Introducing an improved homeowners product in California;
- Expanding to eight additional states;
- Continuing to invest in our technology to make it easier for our agents and customers to transact business with us;
- Increasing the number of qualified agents;
- Converting states with legacy systems to our new technology platform;
- Continuing our Company's transformational leadership program;
- Managing expenses prudently; and
- Continuing our service excellence program.

Combined Ratio vs. Industry

(in percent)



The after-tax yield on investments of 3.6% in 2013 was lower than the after-tax yield of 3.8% obtained in 2012. The current low interest rate environment continues to put downward pressure on our after-tax yield as new money is being invested at lower yields. Our investment base remained steady at about \$3 billion in invested assets for both 2013 and 2012. Going forward, there will be continued downward pressure on our after-tax yield as bonds with higher coupons mature or are called and the reinvestment of those proceeds will most likely be made at lower after-tax yields. During the second half of 2013, the Company sold a significant portion of its equity portfolio to improve the asset risk profile in its insurance subsidiaries and to lock in and realize gains that resulted from the large stock market appreciation that occurred during 2013.

We pride ourselves at having a strong balance sheet. At year-end, our shareholders' equity was \$1.8 billion and our underwriting leverage remains conservative, with a premium to surplus ratio of 1.8 to 1. In November 2013, Mercury's Board of Directors

increased the quarterly dividend rate to \$0.6150 per share, continuing to provide a generous dividend yield based on the recent market price of our stock. Our strong capital position has allowed us to pay a dividend in recent years where the dividend payout ratio was above 100%. We recognize we cannot, on a long term basis, have a payout ratio over 100%; but we also expect to improve profitability. Our Board will continue to evaluate our dividend policy quarterly, and consider factors such as the Company's capital position, earnings, tax law changes and future prospects before a decision is made on the dividend.

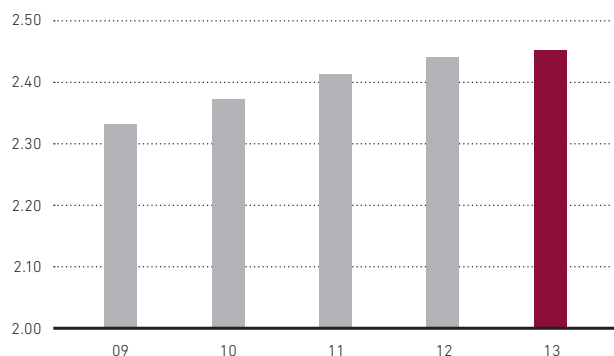
We hope you will be able to attend our annual meeting on May 14, 2014.

Sincerely,



George Joseph
Chairman of the Board

Dividends Per Share
(in dollars)




Gabriel Tirador
President and Chief Executive Officer

10 Year Summary

All dollar figures in thousands, except per share data		2013	2012	2011	2010
OPERATING RESULTS (GAAP BASIS):					
Net premiums written	\$	2,728,999	\$ 2,651,731	\$ 2,575,383	\$ 2,555,481
Change in net unearned premiums		(30,812)	(76,811)	(9,326)	11,204
Net premiums earned		2,698,187	2,574,920	2,566,057	2,566,685
Losses and loss adjustment expenses		1,962,690	1,961,448	1,829,205	1,825,766
Underwriting expenses		724,995	685,069	697,432	760,923
Net investment income		124,538	131,896	140,947	143,814
Net realized investment (losses) gains		(11,422)	66,380	58,397	57,089
Other income		9,738	10,174	11,884	8,297
Interest expense		1,260	1,543	5,549	6,806
Income (loss) before taxes		132,096	135,310	245,099	182,390
Income tax expense (benefit)		19,953	18,399	53,935	30,192
Net income (loss)	\$	112,143	\$ 116,911	\$ 191,164	\$ 152,198
Net income (loss) per share (basic)	\$	2.04	\$ 2.13	\$ 3.49	\$ 2.78
Net income (loss) per share (diluted)	\$	2.04	\$ 2.13	\$ 3.49	\$ 2.78
Operating ratios					
Loss ratio		72.7%	76.2%	71.3%	71.1%
Expense ratio		26.9%	26.6%	27.2%	29.6%
Combined ratio		99.6%	102.8%	98.5%	100.7%
INVESTMENTS:					
Total investments, at fair value	\$	3,158,312	\$ 3,180,095	\$ 3,062,421	\$ 3,155,257
Yield on average investments					
Before taxes		4.1%	4.4%	4.7%	4.6%
After taxes		3.6%	3.8%	4.2%	4.1%
FINANCIAL CONDITION:					
Total assets	\$	4,315,181	\$ 4,189,686	\$ 4,070,006	\$ 4,203,364
Unpaid losses and loss adjustment expenses		1,038,984	1,036,123	985,279	1,034,205
Unearned premiums		953,527	920,429	843,427	833,379
Notes payable		190,000	140,000	140,000	267,210
Policyholders' surplus		1,528,682	1,440,973	1,497,609	1,322,270
Total shareholders' equity		1,822,486	1,842,497	1,857,483	1,794,815
Book value per share	\$	33.15	\$ 33.55	\$ 33.86	\$ 32.75
OTHER INFORMATION:					
Return on average shareholders' equity		6.5%	4.0%	8.4%	6.5%
Basic average shares outstanding		54,947	54,899	54,825	54,792
Shares outstanding at year-end		54,975	54,922	54,856	54,803
Dividends per share	\$	2.4525	\$ 2.4425	\$ 2.41	\$ 2.37
Price range (bids) of common stock	\$	51.00-36.03	\$ 46.76-36.01	\$ 46.61-33.81	\$ 46.66-37.38

	2009		2008		2007		2006		2005		2004
\$	2,589,972	\$	2,750,226	\$	2,982,024	\$	3,044,774	\$	2,950,523	\$	2,646,704
	35,161		58,613		11,853		(47,751)		(102,790)		(118,068)
	2,625,133		2,808,839		2,993,877		2,997,023		2,847,733		2,528,636
	1,782,233		2,060,409		2,036,644		2,021,646		1,862,936		1,582,254
	760,990		799,682		818,481		825,508		769,116		673,838
	144,949		151,280		158,911		151,099		122,582		109,681
	346,444		(550,520)		20,808		15,436		16,160		25,065
	4,967		4,597		5,154		5,185		5,438		4,775
	6,729		4,966		8,589		9,180		7,222		4,222
	571,541		(450,861)		315,036		312,409		352,639		407,843
	168,469		(208,742)		77,204		97,592		99,380		121,635
\$	403,072	\$	(242,119)	\$	237,832	\$	214,817	\$	253,259	\$	286,208
\$	7.36	\$	(4.42)	\$	4.35	\$	3.93	\$	4.64	\$	5.25
\$	7.32	\$	(4.42)	\$	4.34	\$	3.92	\$	4.63	\$	5.24
	67.9%		73.3%		68.0%		67.5%		65.4%		62.6%
	29.0%		28.5%		27.4%		27.5%		27.0%		26.6%
	96.9%		101.8%		95.4%		95.0%		92.4%		89.2%
\$	3,146,857	\$	2,933,820	\$	3,588,675	\$	3,499,738	\$	3,242,712	\$	2,921,042
	4.5%		4.4%		4.6%		4.5%		4.0%		4.1%
	4.1%		3.9%		4.0%		3.8%		3.5%		3.6%
\$	4,232,633	\$	3,950,195	\$	4,414,496	\$	4,301,062	\$	4,050,868	\$	3,622,949
	1,053,334		1,133,508		1,103,915		1,088,822		1,022,603		900,744
	844,540		879,651		938,370		950,344		902,567		799,679
	271,397		158,625		138,562		141,554		143,540		137,024
	1,517,864		1,371,095		1,721,827		1,579,248		1,487,574		1,361,072
	1,770,946		1,494,051		1,861,998		1,724,130		1,607,837		1,459,548
\$	32.33	\$	27.28	\$	34.02	\$	31.54	\$	29.44	\$	26.77
	10.9%		6.9%		12.5%		12.3%		15.8%		19.9%
	54,770		54,744		54,704		54,651		54,566		54,471
	54,777		54,764		54,730		54,670		54,605		54,515
\$	2.33	\$	2.32	\$	2.08	\$	1.92	\$	1.72	\$	1.48
\$	46.09-22.45	\$	62.00-36.11	\$	59.06-48.76	\$	59.90-48.75	\$	60.45-51.16	\$	60.26-46.29

Directors and Officers

BOARD OF DIRECTORS

George Joseph⁴

Chairman of the Board

Gabriel Tirador⁴

President and Chief Executive Officer

Bruce A. Bunner³

Retired President, Financial Structures Ltd.

Michael D. Curtius

Retired President, Mercury General Corporation

James G. Ellis

Dean of the Marshall School of Business
The University of Southern California

Christopher Graves⁴

Vice President and Chief Investment Officer

Richard E. Grayson^{3, 4}

Retired Senior Vice President, Union Bank

Martha E. Marcon^{1, 2}

Retired Partner, KPMG LLP

Donald P. Newell^{1, 2}

Retired Partner,
Law Firm of Latham & Watkins LLP

Donald R. Spuehler^{1, 2, 3}

Retired Partner,
Law Firm of O'Melveny & Myers LLP

EXECUTIVE OFFICERS

George Joseph

Chairman of the Board

Gabriel Tirador

President and Chief Executive Officer

Allan Lubitz

Senior Vice President and Chief Information Officer

Douglas Menges

Senior Vice President and Chief Claims Officer

Theodore R. Stalick

Senior Vice President and Chief Financial Officer

Christopher Graves

Vice President and Chief Investment Officer

Robert Houlihan

Vice President and Chief Product Officer

Kenneth G. Kitzmiller

Vice President and Chief Underwriting Officer

Brandt N. Minnich

Vice President – Marketing

Heidi C. Sullivan

Vice President – Human Capital

Charles Toney

Vice President and Chief Actuary

Judy A. Walters

Vice President – Corporate Affairs and Secretary

¹ Member of Audit Committee

² Member of Nominating/Corporate Governance Committee

³ Member of Compensation Committee

⁴ Member of Investment Committee

This Annual Report document includes Mercury General Corporation's financial statements and supporting data, management's discussion and analysis of financial condition and results of operations and quantitative and qualitative disclosures about market risks from the Company's Form 10-K filed with the Securities and Exchange Commission.

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

FORM 10-K

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

For the Fiscal Year Ended December 31, 2013

Commission File No. 001-12257

MERCURY GENERAL CORPORATION

(Exact name of registrant as specified in its charter)

California

(State or other jurisdiction
of incorporation or organization)

4484 Wilshire Boulevard, Los Angeles, California

(Address of principal executive offices)

95-2211612

(I.R.S. Employer
Identification No.)

90010

(Zip Code)

Registrant's telephone number, including area code: (323) 937-1060

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

Title of Each Class

Common Stock

Name of Each Exchange on Which Registered

New York Stock Exchange

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

NONE

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

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

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

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

Large accelerated filer

☒

Accelerated filer

☐

Non-accelerated filer

☐

(Do not check if a smaller reporting company)

Smaller reporting company

☐

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

The aggregate market value of the Registrant's common equity held by non-affiliates of the Registrant at June 28, 2013 was \$1,181,485,005 (which represents 26,876,365 shares of common equity held by non-affiliates multiplied by \$43.96, the closing sales price on the New York Stock Exchange for such date, as reported by the Wall Street Journal).

At February 3, 2014, the Registrant had issued and outstanding an aggregate of 54,975,317 shares of its Common Stock.

Documents Incorporated by Reference

Certain information from the Registrant's definitive proxy statement for the 2014 Annual Meeting of Shareholders is incorporated herein by reference into Part III hereof.

MERCURY GENERAL CORPORATION
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PART I

Item 1. Business

General

Mercury General Corporation (“Mercury General”) and its subsidiaries (referred to herein collectively as the “Company”) are primarily engaged in writing personal automobile insurance through 13 insurance subsidiaries (referred to herein collectively as the “Insurance Companies”) in 13 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical breakdown, and umbrella insurance. The direct premiums written for the years ended December 31, 2013, 2012, and 2011 by state and line of business were:

Year Ended December 31, 2013 (Amounts in thousands)

	Private Passenger Auto	Homeowners	Commercial Auto	Other Lines	Total	
California	\$ 1,760,352	\$ 267,563	\$ 53,488	\$ 72,617	\$ 2,154,020	78.7%
Florida ⁽¹⁾	133,947	0	22,331	7,433	163,711	6.0%
Other states ⁽²⁾	271,258	72,450	28,870	47,163	419,741	15.3%
Total	\$ 2,165,557	\$ 340,013	\$ 104,689	\$ 127,213	\$ 2,737,472	100.0%
	79.1%	12.4%	3.8%	4.7%	100.0%	

Year Ended December 31, 2012 (Amounts in thousands)

	Private Passenger Auto	Homeowners	Commercial Auto	Other Lines	Total	
California	\$ 1,670,025	\$ 255,418	\$ 41,200	\$ 65,474	\$ 2,032,117	76.5%
Florida ⁽¹⁾	161,720	(181)	14,783	7,118	183,440	6.9%
Other states ⁽²⁾	308,786	63,058	18,672	49,647	440,163	16.6%
Total	\$ 2,140,531	\$ 318,295	\$ 74,655	\$ 122,239	\$ 2,655,720	100.0%
	80.6%	12.0%	2.8%	4.6%	100.0%	

Year Ended December 31, 2011 (Amounts in thousands)

	Private Passenger Auto	Homeowners	Commercial Auto	Other Lines	Total	
California	\$ 1,613,954	\$ 234,616	\$ 48,161	\$ 57,378	\$ 1,954,109	75.8%
Florida	165,506	7,679	14,705	8,974	196,864	7.6%
Other states ⁽²⁾	326,142	42,893	12,776	46,899	428,710	16.6%
Total	\$ 2,105,602	\$ 285,188	\$ 75,642	\$ 113,251	\$ 2,579,683	100.0%
	81.6%	11.1%	2.9%	4.4%	100.0%	

(1) The Company completed its exit from the Florida homeowners market in 2012.

(2) No individual state accounts for more than 5% of total direct premiums written.

The Company offers the following types of automobile coverage: collision, property damage, bodily injury (BI), comprehensive, personal injury protection (PIP), underinsured and uninsured motorist, and other hazards. The Company’s published maximum limits of liability for private passenger automobile insurance are, for BI, \$250,000 per person and \$500,000 per accident, and for property damage, \$250,000 per accident. The combined policy limits may be as high as \$1,000,000 for vehicles written under the Company’s commercial automobile program. However, the majority of the Company’s automobile policies have liability limits that are equal to or less than \$100,000 per person and \$300,000 per accident for BI and \$50,000 per accident for property damage.

The principal executive offices of Mercury General are located in Los Angeles, California. The home office of the Insurance Companies and the information technology center are located in Brea, California. The Company also owns office buildings in Rancho Cucamonga and Folsom, California, which are used to support California operations and future expansion, and in Clearwater, Florida and in Oklahoma City, Oklahoma, which house Company employees and several third party tenants. The Company has approximately 4,500 employees. The Company maintains branch offices in a number of locations in California; Clearwater, Florida; Bridgewater, New Jersey; Oklahoma City, Oklahoma; and Austin and San Antonio, Texas. The Company consolidated its non-California office based claims and underwriting operations into hubs located in Clearwater, Florida; Bridgewater, New Jersey; and Austin, Texas, which resulted in a net workforce reduction of approximately 135 employees and a \$10 million pre-tax expense in the first quarter of 2013.

Website Access to Information

The internet address for the Company's website is www.mercuryinsurance.com. The internet address provided in this Annual Report on Form 10-K is not intended to function as a hyperlink and the information on the Company's website is not and should not be considered part of this report and is not incorporated by reference in this document. The Company makes available on its website its Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements, and amendments to such reports and proxy statements (the "SEC Reports") filed with or furnished to the Securities and Exchange Commission ("SEC") pursuant to federal securities laws, as soon as reasonably practicable after each SEC Report is filed with or furnished to the SEC. In addition, copies of the SEC Reports are available, without charge, upon written request to the Company's Chief Financial Officer, Mercury General Corporation, 4484 Wilshire Boulevard, Los Angeles, California 90010.

Organization

Mercury General, an insurance holding company, is the parent of Mercury Casualty Company, a California automobile insurer founded in 1961 by George Joseph, the Company's Chairman of the Board of Directors. Including Mercury Casualty Company, Mercury General has 19 operating subsidiaries:

<u>Insurance Companies</u>	<u>Date Formed or Acquired</u>	<u>A.M. Best Rating</u>	<u>Primary States</u>
Mercury Casualty Company ("MCC") ⁽¹⁾	January 1961	A+	CA, AZ, NV, NY, VA
Mercury Insurance Company ("MIC") ⁽¹⁾	November 1972	A+	CA
California Automobile Insurance Company ("CAIC") ⁽¹⁾	June 1975	A+	CA
California General Underwriters Insurance Company, Inc. ("CGU") ⁽¹⁾	April 1985	Non-rated	CA
Mercury Insurance Company of Illinois	August 1989	A+	IL, PA
Mercury Insurance Company of Georgia	March 1989	A+	GA
Mercury Indemnity Company of Georgia	November 1991	A+	GA
Mercury National Insurance Company	December 1991	A+	IL, MI
American Mercury Insurance Company	December 1996	A-	OK, GA, TX, VA
American Mercury Lloyds Insurance Company	December 1996	A-	TX
Mercury County Mutual Insurance Company	September 2000	A-	TX
Mercury Insurance Company of Florida	August 2001	A+	FL, PA
Mercury Indemnity Company of America	August 2001	A+	NJ, FL

<u>Non-Insurance Companies</u>	<u>Date Formed or Acquired</u>	<u>Purpose</u>
Mercury Select Management Company, Inc.	August 1997	AML's attorney-in-fact
Mercury Insurance Services LLC	November 2000	Management services to subsidiaries
AIS Management LLC	January 2009	Parent company of AIS and PoliSeek
Auto Insurance Specialists LLC ("AIS")	January 2009	Insurance agent
PoliSeek AIS Insurance Solutions, Inc. ("PoliSeek")	January 2009	Insurance agent
Animas Funding LLC ("AFL")	August 2013	Special purpose investment vehicle
Concord Insurance Services, Inc.	October 1999	Inactive insurance agent, dissolved in 2013.
American Mercury MGA, Inc.	August 1997	Inactive general agent, dissolved in 2012.
Mercury Group, Inc.	July 2001	Inactive insurance agent, dissolved in 2012.

(1) The term "California Companies" refers to MCC, MIC, CAIC, and CGU.

Production and Servicing of Business

The Company sells its policies through approximately 8,300 independent agents, of which over 1,400 are located in each of California and Florida. Approximately half of the Company's agents in California have represented the Company for more than ten years. The agents are independent contractors selected and contracted by the Company and generally also represent competing insurance companies. No independent agent accounted for more than 2% of the Company's direct premiums written during 2013, 2012, and 2011.

The Company believes that it compensates its agents above the industry average. During 2013, total commissions incurred were approximately 17% of net premiums written.

The Company's advertising budget is allocated among television, radio, newspaper, internet, and direct mailing media with the intent to provide the best coverage available within targeted media markets. While the majority of these advertising costs are borne by the Company, a portion of these costs are reimbursed by the Company's independent agents based upon the number of account leads generated by the advertising. The Company believes that its advertising program is important to generate leads, create brand awareness, and remain competitive in the current insurance climate. During 2013, net advertising expenditures were \$19.9 million.

Underwriting

The Company sets its own automobile insurance premium rates, subject to rating regulations issued by the Department of Insurance or similar governmental agency of each state in which it is licensed to operate ("DOI"). Each state has different rate approval requirements. See "Regulation—Department of Insurance Oversight."

The Company offers standard, non-standard, and preferred private passenger automobile insurance. The Company also offers homeowners insurance in 11 states, commercial automobile insurance in 10 states, and mechanical breakdown insurance in most states. The Company completed its exit from the Florida homeowners market in 2012.

In California, "good drivers," as defined by the California Insurance Code, accounted for approximately 82% of all California voluntary private passenger automobile policies-in-force at December 31, 2013, while higher risk categories accounted for approximately 18%. The private passenger automobile renewal rate in California (the rate of acceptance of offers to renew) averages approximately 96%.

Claims

The Company conducts the majority of claims processing without the assistance of outside adjusters. The claims staff administers all claims and manages all legal and adjustment aspects of claims processing.

Losses and Loss Adjustment Expense Reserves and Reserve Development

The Company maintains losses and loss adjustment expense reserves for both reported and unreported claims. Losses and loss adjustment expense reserves for reported claims are estimated based upon a case-by-case evaluation of the type of claim involved and the expected development of such claims. Losses and loss adjustment expense reserves for unreported claims are determined on the

basis of historical information by line of insurance. Inflation is reflected in the reserving process through analysis of cost trends and review of historical reserve settlement.

The Company's ultimate liability may be greater or less than management estimates of reported losses and loss adjustment expense reserves. Reserves are analyzed quarterly by the Company's actuarial consultants using current information on reported claims and a variety of statistical techniques. The Company does not discount to a present value that portion of losses and loss adjustment expense reserves expected to be paid in future periods. Federal tax law, however, requires the Company to discount losses and loss adjustment expense reserves for federal income tax purposes.

The following table presents the development of losses and loss adjustment expense reserves for the period 2003 through 2013. The top section of the table shows the reserves at the balance sheet date, net of reinsurance recoverable, for each of the indicated years. This amount represents the estimated net losses and loss adjustment expenses for claims arising from the current and all prior years that are unpaid at the balance sheet date, including an estimate for losses that had been incurred but not reported ("IBNR") to the Company. The second section shows the cumulative amounts paid as of successive years with respect to that reserve liability. The third section shows the re-estimated amount of the previously recorded reserves based on experience as of the end of each succeeding year, including cumulative payments made since the end of the respective year. Estimates change as more information becomes known about the frequency and severity of claims for individual years. The bottom line shows favorable (unfavorable) development that exists when the original reserve estimates are greater (less) than the re-estimated reserves at December 31, 2013.

In evaluating the cumulative development information in the table, it should be noted that each amount includes the effects of all changes in development amounts for prior periods. This table does not present accident or policy year development data. Conditions and trends that have affected development of the liability in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future favorable or unfavorable development based on this table.

	December 31,										
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(Amounts in thousands)										
Gross Reserves for Losses and Loss Adjustment Expenses-end of year ⁽¹⁾	\$ 797,927	\$ 900,744	\$ 1,022,603	\$ 1,088,822	\$ 1,103,915	\$ 1,133,508	\$ 1,053,334	\$ 1,034,205	\$ 985,279	\$ 1,036,123	\$ 1,038,984
Reinsurance recoverable	(11,771)	(14,137)	(16,969)	(6,429)	(4,457)	(5,729)	(7,748)	(6,805)	(7,921)	(12,155)	(13,927)
Net Reserves for Losses and Loss Adjustment Expenses-end of year ⁽¹⁾	\$ 786,156	\$ 886,607	\$ 1,005,634	\$ 1,082,393	\$ 1,099,458	\$ 1,127,779	\$ 1,045,586	\$ 1,027,400	\$ 977,358	\$ 1,023,968	\$ 1,025,057
Paid (cumulative) as of:											
One year later	\$ 461,649	\$ 525,125	\$ 632,905	\$ 674,345	\$ 715,846	\$ 617,622	\$ 603,256	\$ 614,059	\$ 600,090	\$ 607,527	
Two years later	628,280	748,255	891,928	975,086	1,009,141	913,518	889,806	896,363	873,679		
Three years later	714,763	851,590	1,027,781	1,123,179	1,168,246	1,059,627	1,023,137	1,027,006			
Four years later	740,534	893,436	1,077,834	1,187,990	1,229,939	1,118,230	1,075,174				
Five years later	750,927	906,466	1,101,693	1,211,343	1,252,687	1,138,546					
Six years later	754,710	915,086	1,111,109	1,219,719	1,262,286						
Seven years later	760,300	918,008	1,114,241	1,224,026							
Eight years later	762,385	918,488	1,115,824								
Nine years later	762,602	918,690									
Ten years later	762,709										
Net reserves re-estimated as of:											
One year later	728,213	840,090	1,026,923	1,101,917	1,188,100	1,069,744	1,032,528	1,045,894	1,019,690	1,026,928	
Two years later	717,289	869,344	1,047,067	1,173,753	1,219,369	1,102,934	1,076,480	1,073,052	1,056,453		
Three years later	745,744	894,063	1,091,131	1,202,441	1,246,365	1,136,278	1,085,591	1,094,494			
Four years later	750,859	910,171	1,104,988	1,217,328	1,263,294	1,141,714	1,095,907				
Five years later	755,970	914,547	1,112,779	1,225,051	1,263,560	1,147,149					
Six years later	757,534	918,756	1,115,637	1,225,131	1,265,186						
Seven years later	762,242	919,397	1,115,916	1,225,519							
Eight years later	763,016	919,027	1,116,494								
Nine years later	762,948	919,165									
Ten years later	763,016										
Net cumulative development favorable (unfavorable)	\$ 23,140	\$ (32,558)	\$ (110,860)	\$ (143,126)	\$ (165,728)	\$ (19,370)	\$ (50,321)	\$ (67,094)	\$ (79,095)	\$ (2,960)	
Gross re-estimated liability-latest	\$ 792,420	\$ 947,047	\$ 1,149,022	\$ 1,246,105	\$ 1,282,356	\$ 1,157,688	\$ 1,110,567	\$ 1,108,205	\$ 1,068,407	\$ 1,041,316	
Re-estimated recoverable-latest	(29,404)	(27,882)	(32,528)	(20,586)	(17,170)	(10,539)	(14,660)	(13,711)	(11,954)	(14,388)	
Net re-estimated liability-latest	\$ 763,016	\$ 919,165	\$ 1,116,494	\$ 1,225,519	\$ 1,265,186	\$ 1,147,149	\$ 1,095,907	\$ 1,094,494	\$ 1,056,453	\$ 1,026,928	
Gross cumulative development favorable (unfavorable)	\$ 5,507	\$ (46,303)	\$ (126,419)	\$ (157,283)	\$ (178,441)	\$ (24,180)	\$ (57,233)	\$ (74,000)	\$ (83,128)	\$ (5,193)	

(1) Under statutory accounting principles ("SAP"), reserves are stated net of reinsurance recoverable whereas under U.S. generally accepted accounting principles ("GAAP"), reserves are stated gross of reinsurance recoverable.

The Company experienced unfavorable development of approximately \$3 million on the 2012 and prior accident years' loss and loss adjustment expense reserves due primarily to Florida claims that were re-opened from prior years due to a state supreme court ruling that was adverse to the insurance industry. See "Critical Accounting Policies and Estimates-Reserves" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

For 2011, the Company experienced unfavorable development of approximately \$79 million on prior accident years' loss and loss adjustment expense reserves due primarily to an increase in the estimated loss severity for California BI losses. In addition, the Company experienced unfavorable development on the run-off of California commercial taxi business and Florida homeowners lines of business, both of which the Company ceased writing in 2011.

For the years 2008 through 2010, the Company experienced unfavorable development of approximately \$19 million to \$67 million on prior accident years' losses and loss adjustment expense reserves. The unfavorable development was primarily due to increases in the estimated loss severity for California BI losses, increases in PIP reserves in Florida resulting from court decisions that

were adverse to the insurance industry, and development on 2007 and prior accident years in New Jersey BI reserves that settled for more than anticipated. These were partially offset by reductions in estimates for loss adjustment expenses, particularly for the 2010 accident year, related to the transfer of a higher proportion of litigated claims to house counsel and a reduction in the estimate for Florida sinkhole claims for accident year 2010, resulting from many of those claims being denied due to the absence of sinkhole activity or structural damage to the houses.

For the years 2005 through 2007, the Company experienced unfavorable development of approximately \$111 million to \$166 million on prior accident years' losses and loss adjustment expense reserves. The unfavorable development from these years related primarily to increases in loss severity estimates and loss adjustment expense estimates for the California BI coverage as well as increases in the provision for BI and PIP losses in New Jersey and Florida.

For 2004, the unfavorable development related to an increase in the Company's prior accident years' loss estimates for personal automobile insurance in Florida and New Jersey. In addition, an increase in estimates for loss severity for the 2004 accident year reserves for California and New Jersey automobile lines of business contributed to the deficiencies.

For 2003, the favorable development largely related to lower inflation than originally expected on the BI coverage reserves for the California automobile line of insurance. In addition, the Company experienced a reduction in expenditures to outside legal counsel for the defense of personal automobile claims in California. This led to a reduction in the ultimate expense amount expected to be paid out and therefore favorable development in the reserves at December 31, 2003, partially offset by unfavorable development in the Florida automobile lines of business.

Statutory Accounting Principles

The Company's results are reported in accordance with GAAP, which differ in some respects from amounts reported under SAP prescribed by insurance regulatory authorities. Some of the significant differences under GAAP are described below:

- Policy acquisition costs such as commissions, premium taxes, and other costs that vary with and are primarily related to the successful acquisition of new and renewal insurance contracts, are capitalized and amortized on a pro rata basis over the period in which the related premiums are earned, rather than expensed as incurred, as required by SAP.
- Certain assets are included in the consolidated balance sheets whereas, under SAP, such assets are designated as "nonadmitted assets," and charged directly against statutory surplus. These assets consist primarily of premium receivables outstanding more than 90 days, deferred tax assets that do not meet statutory requirements for recognition, furniture, equipment, leasehold improvements, capitalized software, and prepaid expenses.
- Amounts related to ceded reinsurance are shown gross as prepaid reinsurance premiums and reinsurance recoverables, rather than netted against unearned premium reserves and losses and loss adjustment expenses reserves, respectively, as required by SAP.
- Fixed-maturity securities are reported at fair value rather than at amortized cost, or the lower of amortized cost or fair value, depending on the specific type of security as required by SAP.
- Equity securities are marked to market through the consolidated statements of operations rather than through unrealized gains and losses in surplus, as required by SAP.
- Goodwill is reported as the excess of cost of an acquired entity over the fair value of the underlying assets and assessed periodically for impairment. Intangible assets are amortized over their useful lives. Under SAP, goodwill is reported as the excess of cost of an acquired entity over the statutory book value and amortized over 10 years. Its carrying value is limited to 10% of adjusted surplus. Intangible assets are not recognized.
- The differing treatment of income and expense items results in a corresponding difference in federal income tax expense. Changes in deferred income taxes are reflected as an item of income tax benefit or expense, rather than recorded directly to statutory surplus as regards policyholders, as required by SAP. Admittance testing under SAP may result in a charge to unassigned surplus for non-admitted portions of deferred tax assets. Under GAAP, a valuation allowance may be recorded against the deferred tax assets and reflected as an expense.
- Certain assessments paid to regulatory agencies that are recoverable from policyholders in future periods are expensed rather than recorded as receivables under SAP.

Operating Ratios (SAP basis)

Loss and Expense Ratios

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. Under SAP, losses and loss adjustment expenses are stated as a percentage of premiums earned because losses occur over the life of a policy, while underwriting expenses are stated as a percentage of premiums written rather than premiums earned because most underwriting expenses are incurred when policies are written and are not spread over the policy period. The statutory underwriting profit margin is the extent to which the combined loss and expense ratios are less than 100%. The Insurance Companies' loss ratio, expense ratio, combined ratio, and the private passenger automobile industry combined ratio, on a statutory basis, are shown in the following table. Though the Insurance Companies' ratios include lines of insurance other than private passenger automobile, which represent 20.9% of premiums written, the Company believes its ratios can be compared to the industry ratios included in the following table.

	Year Ended December 31,				
	2013	2012	2011	2010	2009
Loss Ratio	72.7%	76.1%	71.2%	71.0%	67.8%
Expense Ratio	27.2%	26.7%	27.4%	29.1%	28.6%
Combined Ratio	99.9%	102.8%	98.6%	100.1%	96.4%
Industry combined ratio (all writers) ⁽¹⁾	100.8% ⁽²⁾	101.3%	101.6%	100.4%	100.8%
Industry combined ratio (excluding direct writers) ⁽¹⁾	N/A	102.6%	101.1%	101.1%	100.5%

(1) Source: A.M. Best, *Aggregates & Averages* (2010 through 2013), for all property and casualty insurance companies (private passenger automobile line only, after policyholder dividends).

(2) Source: A.M. Best, "*Best's Special Report U.S. Property/Casualty-Review & Preview*, February 4, 2014."

Premiums to Surplus Ratio

The following table presents, for the periods indicated, the Insurance Companies' statutory ratios of net premiums written to policyholders' surplus. Guidelines established by the National Association of Insurance Commissioners (the "NAIC") indicate that this ratio should be no greater than 3 to 1.

	Year Ended December 31,				
	2013	2012	2011	2010	2009
	(Amounts in thousands, except ratios)				
Net premiums written	\$ 2,728,999	\$ 2,651,731	\$ 2,575,383	\$ 2,555,481	\$ 2,589,972
Policyholders' surplus	\$ 1,528,682	\$ 1,440,973	\$ 1,497,609	\$ 1,322,270	\$ 1,517,864
Ratio	1.8 to 1	1.8 to 1	1.7 to 1	1.9 to 1	1.7 to 1

Investments

The Company's investments are directed by the Chief Investment Officer under the supervision of the Board of Directors. 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 a 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 believes that this strategy maintains the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for monitoring credit exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

Tax considerations, including the impact of the alternative minimum tax ("AMT"), are important in portfolio management. Changes in loss experience, growth rates, and profitability produce significant changes in the Company's exposure to AMT liability, requiring appropriate shifts in the investment asset mix between taxable bonds, tax-exempt bonds, and equities in order to maximize after-tax yield. The Company closely monitors the timing and recognition of capital gains and losses and

the generation of ordinary income to maximize the realization of any deferred tax assets arising from capital losses or AMT credit carryforwards, respectively. The Company had no capital loss carryforward at December 31, 2013.

Investment Portfolio

The following table presents the composition of the Company's total investment portfolio:

	December 31,					
	2013		2012		2011	
	Cost ⁽¹⁾	Fair Value	Cost ⁽¹⁾	Fair Value	Cost ⁽¹⁾	Fair Value
	(Amounts in thousands)					
Taxable bonds	\$ 329,521	\$ 331,506	\$ 253,175	\$ 265,671	\$ 166,295	\$ 180,257
Tax-exempt state and municipal bonds	2,193,521	2,229,147	2,017,728	2,142,683	2,179,325	2,265,332
Total fixed maturities	2,523,042	2,560,653	2,270,903	2,408,354	2,345,620	2,445,589
Equity securities	223,933	281,883	475,959	477,088	388,417	380,388
Short-term investments	315,886	315,776	294,607	294,653	236,433	236,444
Total investments	<u>\$ 3,062,861</u>	<u>\$ 3,158,312</u>	<u>\$ 3,041,469</u>	<u>\$ 3,180,095</u>	<u>\$ 2,970,470</u>	<u>\$ 3,062,421</u>

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

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time the eligible item is first recognized. For more detailed discussion, see "Liquidity and Capital Resources—Invested Assets" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 2 of Notes to Consolidated Financial Statements.

At December 31, 2013, 70.6% of the Company's total investment portfolio at fair value and 87.1% of its total fixed maturity investments at fair value were invested in tax-exempt state and municipal bonds. For more detailed information including credit ratings, see "Liquidity and Capital Resources—Portfolio Composition" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

The nominal average maturity of the overall bond portfolio was 13.3 years (12.1 years including short-term instruments) at December 31, 2013. The portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity investments purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The call-adjusted average maturity of the overall bond portfolio was 5.2 years (4.7 years including short-term instruments) at December 31, 2013 related to holdings which are heavily weighted with high coupon issues that are expected to be called prior to maturity. The modified duration of the overall bond portfolio reflecting anticipated early calls was 3.9 years (3.6 years including short-term instruments) at December 31, 2013, including collateralized mortgage obligations with a modified duration of 2.3 years and short-term bonds that carry no duration. 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 longer the duration, the more sensitive the asset is to market interest rate fluctuations.

Equity holdings consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and a partnership interest in a private credit fund. During the second half of 2013, the Company sold a significant portion of its equity portfolio to improve the asset risk profile in its insurance subsidiaries and to lock in and realize gains that resulted from the large stock market appreciation that occurred during 2013. Those gains can be utilized to offset capital losses for tax purposes within the next three years.

At year end, 83.3% 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.

Investment Results

The following table presents the investment results of the Company for the most recent five years:

	Year Ended December 31,				
	2013	2012	2011	2010	2009
	(Amounts in thousands)				
Average invested assets at cost ⁽¹⁾	\$ 3,028,198	\$ 3,011,143	\$ 3,004,588	\$ 3,121,366	\$ 3,196,944
Net investment income ⁽²⁾					
Before income taxes	\$ 124,538	\$ 131,896	\$ 140,947	\$ 143,814	\$ 144,949
After income taxes	\$ 109,506	\$ 115,359	\$ 124,708	\$ 128,888	\$ 130,070
Average annual yield on investments ⁽²⁾					
Before income taxes	4.1%	4.4%	4.7%	4.6%	4.5%
After income taxes	3.6%	3.8%	4.2%	4.1%	4.1%
Net realized investment (losses) gains after income taxes	\$ (7,424)	\$ 43,147	\$ 37,958	\$ 37,108	\$ 225,189

- (1) Fixed maturities and short-term bonds at amortized cost; and 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 respective period.
- (2) Net investment income and average annual yield decreased primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during a low interest rate environment.

Competitive Conditions

The Company operates in the highly competitive property and casualty insurance industry subject to competition on pricing, claims handling, consumer recognition, coverage offered and product features, customer service, and geographic coverage. Some of the Company's competitors are larger and well-capitalized national companies which have broad distribution networks of employed or captive agents.

Reputation for customer service and price are the principal means by which the Company competes with other insurers. In addition, the marketing efforts of independent agents can provide a competitive advantage. Based on the most recent regularly published statistical compilations of premiums written in 2013, the Company was the fifth largest writer of private passenger automobile insurance in California and the thirteenth largest in the United States.

The property and casualty insurance industry is highly cyclical, with alternating hard and soft market conditions. The Company has historically seen significant premium growth during hard markets. The Company believes that the market is mixed with carriers both raising and decreasing rates depending on individual state profitability and the carriers' growth appetite.

Reinsurance

The Company entered into a Catastrophe Reinsurance Treaty ("Treaty") effective July 1, 2013 through June 30, 2014. The Treaty provides for \$100 million coverage on a per occurrence basis after covered catastrophe losses exceed a \$100 million Company retention limit. The Treaty provides coverage for property and automobile physical damage and excludes losses from earthquake, fire following earthquake, and Florida automobile physical damage. The annual premium is \$4.25 million.

The Company has reinsurance for PIP claims in Michigan through the Michigan Catastrophic Claims Association, a private non-profit unincorporated association created by the Michigan Legislature. The reinsurance covers losses in excess of \$530,000 per person and has no maximum limit. Michigan law provides for unlimited lifetime coverage for medical costs caused by automobile accidents.

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. For more detailed discussion, see "Regulation—Insurance Assessments."

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.

Regulation

The Insurance Companies are subject to significant regulation and supervision by insurance departments of the jurisdictions in which they are domiciled or licensed to operate business.

Department of Insurance Oversight

The powers of the DOI in each state primarily include the prior approval of insurance rates and rating factors and the establishment of capital and surplus requirements, solvency standards, restrictions on dividend payments and transactions with affiliates. DOI regulations and supervision are designed principally to benefit policyholders rather than shareholders.

California Proposition 103 requires that property and casualty insurance rates be approved by the California DOI prior to their use and that no rate be approved which is excessive, inadequate, unfairly discriminatory, or otherwise in violation of the provisions of the initiative. The proposition specifies four statutory factors required to be applied in “decreasing order of importance” in determining rates for private passenger automobile insurance: (1) the insured’s driving safety record, (2) the number of miles the insured drives annually, (3) the number of years of driving experience of the insured and (4) whatever optional factors are determined by the California DOI to have a substantial relationship to risk of loss and are adopted by regulation. The statute further provides that insurers are required to give at least a 20% discount to “good drivers,” as defined, from rates that would otherwise be charged to such drivers and that no insurer may refuse to insure a “good driver.” The Company’s rate plan operates under these rating factor regulations.

The Company filed for a 3.9% rate increase for its California homeowners line of business in May 2009. After a rate hearing by an Administrative Law Judge (“ALJ”), the Company was ordered by the California Insurance Commissioner to reduce rates by 5.5%, which was implemented during the second quarter of 2013. The Company is challenging in Superior Court some of the issues that were raised by the ALJ in the rate hearing. The Company subsequently filed for a rate increase that contained more recent data, and an 8.26% rate increase was approved by the California Insurance Commissioner. The rate increase went into effect in January 2014.

In January 2013, the California DOI approved an auto body repair regulation intended to strengthen consumer protection. This regulation requires insurers to settle automobile insurance claims using repair standards described by the regulation and not by the insurers’ own standards. The new ruling became effective in March 2013. While the impact of the new ruling was minimal during 2013, it may increase the cost of parts for auto repairs in the future.

Insurance rates in Georgia, New York, New Jersey, Pennsylvania, and Nevada require prior approval from the state DOI, while insurance rates in Illinois, Texas, Virginia, Arizona, and Michigan must only be filed with the respective DOI before they are implemented. Oklahoma and Florida have a modified version of prior approval laws. In all states, the insurance code provides that rates must not be excessive, inadequate, or unfairly discriminatory.

The DOI in each state in which the Company operates is responsible for conducting periodic financial and market conduct 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 financial and market conduct examinations:

State	Exam Type	Period Under Review	Status
CA	Financial	2011 to 2013	Fieldwork will begin in the first quarter of 2014.
FL	Financial	2011 to 2013	Fieldwork will begin in the first quarter of 2014.
TX	Financial	2011 to 2013	Fieldwork will begin in the first quarter of 2014.
CA	Market Conduct	2012 to 2013	Fieldwork will begin in the first quarter of 2014.

During the course of and at the conclusion of these examinations, the examining DOI generally reports findings to the Company, and none of the findings reported to date is expected to be material to the Company’s financial position.

For a discussion of current regulatory matters in California, see “Regulatory and Legal Matters” in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

The operations of the Company are dependent on the laws of the states in which it does business and changes in those laws can materially affect the revenue and expenses of the Company. The Company retains its own legislative advocates in California. The Company made direct financial contributions of \$18,100 and \$237,400 to officeholders and candidates in 2013 and 2012, respectively. The Company believes in supporting the political process and intends to continue to make such contributions in amounts which it determines to be appropriate.

Risk-Based Capital

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The risk-based capital (“RBC”) formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2013, 2012, and 2011 each of the Insurance Companies exceeded the minimum required RBC levels, as determined by the NAIC and adopted by the state insurance regulators. None of the Insurance Companies’ RBC ratio was less than 500% of the authorized control level RBC as of December 31, 2013, 2012, and 2011, respectively. Generally, an RBC ratio of 200% or less would require some form of regulatory or company action.

Own Risk and Solvency Assessment

Beginning in 2015, insurance companies will be required to file an Own Risk and Solvency Assessment (“ORSA”) with the insurance regulators in their state of domicile. The ORSA is required to cover, among many items, a company’s risk management policies, the material risks to which the company is exposed, how the company measures, monitors, manages and mitigates material risks, and how much economic and regulatory capital is needed to continue to operate in a strong and healthy manner. The ORSA will be used by the state insurance regulator to evaluate the risk exposure and quality of the risk management processes within the insurance companies to assist in conducting risk-focused financial examinations and for determining the overall financial condition of the insurance company.

Insurance Assessments

The California Insurance Guarantee Association (“CIGA”) was created to pay claims on behalf of insolvent property and casualty insurers. Each year, these claims are estimated by CIGA and the Company is assessed for its pro-rata share based on prior year California premiums written in the particular line. These assessments are limited to 2.25% of premiums written in the preceding year and are recouped through a mandated surcharge to policyholders in the year after the assessment. There were no CIGA assessments in 2013.

During 2013, the Company paid approximately \$1.5 million in assessments to the New Jersey Unsatisfied Claim and Judgment Fund and the New Jersey Property-Liability Insurance Guaranty Association for assessments relating to its personal automobile line of insurance. As permitted by state law, the New Jersey assessments paid during 2013 are recoupable through a surcharge to policyholders. It is likely that there will be additional assessments in 2014.

The CEA is a quasi-governmental organization that was established to provide a market for earthquake coverage to California homeowners. The Company places all new and renewal earthquake coverage offered with its homeowner policy directly with the CEA. The Company receives a small fee for placing business with the CEA, which is recorded as other revenue in the consolidated statements of operations. Upon the occurrence of a major seismic event, the CEA has the ability to assess participating companies for losses. These assessments are made after CEA capital has been expended and are based upon each company’s participation percentage multiplied by the amount of the total assessment. Based upon the most recent information provided by the CEA, the Company’s maximum total exposure to CEA assessments at April 1, 2013, the most recent date at which information was available, was \$60.4 million. There was no assessment made in 2013.

The Insurance Companies in other states are also subject to the provisions of similar insurance guaranty associations. There were no material assessment payments during 2013 in other states.

Holding Company Act

The California Companies are subject to California DOI regulation pursuant to the provisions of the California Insurance Holding Company System Regulatory Act (the “Holding Company Act”). The California DOI may examine the affairs of each of the California Companies at any time. The Holding Company Act requires disclosure of any material transactions among affiliates within a Holding Company System. Some transactions and dividends defined to be of an “extraordinary” type may not be made if the California DOI disapproves the transaction within 30 days after notice. Such transactions include, but are not limited to, extraordinary dividends; management agreements, service contracts, and cost-sharing arrangements; all guarantees that are not

quantifiable; derivative transactions or series of derivative transactions; certain reinsurance transactions or modifications thereof in which the reinsurance premium or a change in the insurer's liabilities equals or exceeds 5 percent of the policyholders' surplus as of the preceding December 31; sales, purchases, exchanges, loans, and extensions of credit; and investments, in the net aggregate, involving more than the lesser of 3% of the respective California Companies' admitted assets or 25% of statutory surplus as regards policyholders as of the preceding December 31. An extraordinary dividend is a dividend which, together with other dividends or distributions made within the preceding 12 months, exceeds the greater of 10% of the insurance company's statutory policyholders' surplus as of the preceding December 31 or the insurance company's statutory net income for the preceding calendar year.

An insurance company is also required to notify the California DOI of any dividend after declaration, but prior to payment. There are similar limitations imposed by other states on the Insurance Companies' ability to pay dividends. As of December 31, 2013, the Insurance Companies are permitted to pay in 2014, without obtaining DOI approval for extraordinary dividends, \$260.2 million in dividends to Mercury General, of which \$238.1 million may be paid by the California Companies.

The Holding Company Act also provides that the acquisition or change of "control" of a California domiciled insurance company or of any person who controls such an insurance company cannot be consummated without the prior approval of the California DOI. In general, a presumption of "control" arises from the ownership of voting securities and securities that are convertible into voting securities, which in the aggregate constitute 10% or more of the voting securities of a California insurance company or of a person that controls a California insurance company, such as Mercury General. A person seeking to acquire "control," directly or indirectly, of the Company must generally file with the California DOI an application for change of control containing certain information required by statute and published regulations and provide a copy of the application to the Company. The Holding Company Act also effectively restricts the Company from consummating certain reorganizations or mergers without prior regulatory approval.

Each of the Insurance Companies is subject to holding company regulations in the state in which it is domiciled. These provisions are substantially similar to those of the Holding Company Act.

Assigned Risks

Automobile liability insurers in California are required to sell BI liability, property damage liability, medical expense, and uninsured motorist coverage to a proportionate number (based on the insurer's share of the California automobile casualty insurance market) of those drivers applying for placement as "assigned risks." Drivers seek placement as assigned risks because their driving records or other relevant characteristics, as defined by Proposition 103, make them difficult to insure in the voluntary market. In 2013, assigned risks represented less than 0.1% of total automobile direct premiums written and less than 0.1% of total automobile direct premium earned. The Company attributes the low level of assignments to the competitive voluntary market. Many of the other states in which the Company conducts business offer programs similar to that of California. These programs are not a significant contributor to the business written in those states.

Executive Officers of the Company

The following table presents certain information concerning the executive officers of the Company as of February 3, 2014:

Name	Age	Position
George Joseph	92	Chairman of the Board
Gabriel Tirador	49	President and Chief Executive Officer
Allan Lubitz	55	Senior Vice President and Chief Information Officer
Douglas Menges	55	Senior Vice President and Chief Claims Officer
Theodore R. Stalick	50	Senior Vice President and Chief Financial Officer
Christopher Graves	48	Vice President and Chief Investment Officer
Robert Houlihan	57	Vice President and Chief Product Officer
Kenneth G. Kitzmiller	67	Vice President and Chief Underwriting Officer
Brandt N. Minnich	47	Vice President—Marketing
Heidi C. Sullivan	45	Vice President—Human Capital
Charles Toney	52	Vice President and Chief Actuary
Judy A. Walters	67	Vice President—Corporate Affairs and Secretary

Mr. Joseph, Chairman of the Board of Directors, has served in this capacity since 1961. He held the position of Chief Executive Officer of the Company for 45 years from 1961 through December 2006. Mr. Joseph has more than 50 years' experience in the property and casualty insurance business.

Mr. Tirador, President and Chief Executive Officer, served as the Company's assistant controller from 1994 to 1996. In 1997 and 1998, he served as the Vice President and Controller of the Automobile Club of Southern California. He rejoined the Company in 1998 as Vice President and Chief Financial Officer. He was appointed President and Chief Operating Officer in October 2001 and Chief Executive Officer in January 2007. Mr. Tirador has over 20 years experience in the property and casualty insurance industry and is an inactive Certified Public Accountant.

Mr. Lubitz, Senior Vice President and Chief Information Officer, joined the Company in January 2008. Prior to joining the Company, he served as Senior Vice President and Chief Information Officer of Option One Mortgage from 2003 to 2007. He held executive roles including Chief Information Officer of Ditech Mortgage and President of ANR Consulting Group from 2000 to 2003. Prior to 2000, he held several positions at TRW, Experian, and First American Corporation, most recently as a Senior Vice President and Chief Information Officer.

Mr. Menges, Senior Vice President and Chief Claims Officer, joined the Company in August 2013. Prior to joining the Company, he served as Senior Vice President of Auto Claims at Farmers Insurance from 2008 to 2013 and served in other operational positions at Farmers Insurance from 1997 to 2008.

Mr. Stalick, Senior Vice President and Chief Financial Officer, joined the Company as Corporate Controller in 1997. He was appointed Chief Accounting Officer in October 2000 and Vice President and Chief Financial Officer in October 2001. In July 2013, he was named Senior Vice President and Chief Financial Officer. Mr. Stalick is an inactive Certified Public Accountant.

Mr. Graves, Vice President and Chief Investment Officer, has been employed by the Company in the investment department since 1986. Mr. Graves was appointed Chief Investment Officer in 1998, and named Vice President in April 2001.

Mr. Houlihan, Vice President and Chief Product Officer, joined the Company in his current position in November 2007. Prior to joining the Company, he served as National Product Manager at Bristol West Insurance Group from 2005 to 2007 and Product Manager at Progressive Insurance Company from 1999 to 2005.

Mr. Kitzmiller, Vice President and Chief Underwriting Officer, has been employed by the Company in the underwriting department since 1972. Mr. Kitzmiller was appointed Vice President in 1991, and named Chief Underwriting Officer in January 2010.

Mr. Minnich, Vice President—Marketing, joined the Company as an underwriter in 1989. In 2007, he joined Superior Access Insurance Services as Director of Agency Operations and rejoined the Company as an Assistant Product Manager in 2008. In 2009, he was named Senior Director of Marketing, a role he held until appointed to his current position later in 2009. Mr. Minnich has over 20 years experience in the property and casualty insurance industry and is a Chartered Property and Casualty Underwriter.

Ms. Sullivan, Vice President—Human Capital, joined the Company in September 2012. Prior to joining the Company, she served as Senior Vice President, Human Capital for Arcadian Health Plan from 2008 to 2012. Prior to 2008, she held various leadership positions at Kaiser Permanente, Progressive Insurance, and Score Educational Centers.

Mr. Toney, Vice President and Chief Actuary, joined the Company in 1984 as a programmer/analyst. In 1994, he earned his Fellowship in the Casualty Actuarial Society and was appointed to his current position. In 2011, he became a board member of the Personal Insurance Federation of California. Mr. Toney is Mr. Joseph's nephew.

Ms. Walters, Vice President—Corporate Affairs and Secretary, has been employed by the Company since 1967, and has served as its Secretary since 1982. Ms. Walters was named Vice President—Corporate Affairs in 1998.

Item 1A. Risk Factors

The Company's business involves various risks and uncertainties in addition to the normal risks of business, some of which are discussed in this section. It should be noted that the Company's business and that of other insurers may be adversely affected by a downturn in general economic conditions and other forces beyond the Company's control. In addition, other risks and uncertainties not presently known or that the Company currently believes to be immaterial may also adversely affect the Company's business. Any such risks or uncertainties, or any of the following risks or uncertainties, that develop into actual events could result in a material and adverse effect on the Company's business, financial condition, results of operations, or liquidity.

The information discussed below should be considered carefully with the other information contained in this Annual Report on Form 10-K and the other documents and materials filed by the Company with the SEC, as well as news releases and other information publicly disseminated by the Company from time to time.

Risks Related to the Company's Business

The Company remains highly dependent upon California and several other key states to produce revenues and operating profits.

For the year ended December 31, 2013, the Company generated 79.9% of its direct automobile insurance premiums written in California and 6.9% in Florida. The Company's financial results are subject to prevailing regulatory, legal, economic, demographic, competitive, and other conditions in these states and changes in any of these conditions could negatively impact the Company's results of operations.

Mercury General is a holding company that relies on regulated subsidiaries for cash operating profits to satisfy its obligations.

As a holding company, Mercury General maintains no operations that generate revenue sufficient to pay operating expenses, shareholders' dividends, or principal or interest on its indebtedness. Consequently, Mercury General relies on the ability of the Insurance Companies, particularly the California Companies, to pay dividends for Mercury General to meet its obligations. The ability of the Insurance Companies to pay dividends is regulated by state insurance laws, which limit the amount of, and in certain circumstances may prohibit the payment of, cash dividends. Generally, these insurance regulations permit the payment of dividends only out of earned surplus in any year which, together with other dividends or distributions made within the preceding 12 months, do not exceed the greater of 10% of statutory surplus as of the end of the preceding year or the net income for the preceding year, with larger dividends payable only after receipt of prior regulatory approval. The inability of the Insurance Companies to pay dividends in an amount sufficient to enable the Company to meet its cash requirements at the holding company level could have a material adverse effect on the Company's results of operations, financial condition, and its ability to pay dividends to its shareholders.

The Insurance Companies are subject to minimum capital and surplus requirements, and any failure to meet these requirements could subject the Insurance Companies to regulatory action.

The Insurance Companies are subject to risk-based capital standards and other minimum capital and surplus requirements imposed under applicable laws of their state of domicile. The risk-based capital standards, based upon the Risk-Based Capital Model Act adopted by the NAIC, require the Insurance Companies to report their results of RBC calculations to state departments of insurance and the NAIC. If any of the Insurance Companies fails to meet these standards and requirements, the DOI regulating such subsidiary may require specified actions by the subsidiary.

The Company's success depends on its ability to accurately underwrite risks and to charge adequate premiums to policyholders.

The Company's financial condition, results of operations, and liquidity depend on its ability to underwrite and set premiums accurately for the risks it assumes. Premium rate adequacy is necessary to generate sufficient premium to offset losses, loss adjustment expenses, and underwriting expenses and to earn a profit. In order to price its products accurately, the Company must collect and properly analyze a substantial volume of data; develop, test, and apply appropriate rating formulae; closely monitor and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. The Company's ability to undertake these efforts successfully, and as a result, price accurately, is subject to a number of risks and uncertainties, including but not limited to:

- availability of sufficient reliable data;
- incorrect or incomplete analysis of available data;
- uncertainties inherent in estimates and assumptions, generally;
- selection and application of appropriate rating formulae or other pricing methodologies;
- successful innovation of new pricing strategies;
- recognition of changes in trends and in the projected severity and frequency of losses;
- the Company's ability to forecast renewals of existing policies accurately;
- unanticipated court decisions, legislation or regulatory action;

- ongoing changes in the Company's claim settlement practices;
- changes in operating expenses;
- changing driving patterns;
- extra-contractual liability arising from bad faith claims;
- weather catastrophes, including those which may be related to climate change;
- losses from sinkhole claims;
- unexpected medical inflation; and
- unanticipated inflation in auto repair costs, auto parts prices, and used car prices.

Such risks may result in the Company's pricing being based on outdated, inadequate or inaccurate data, or inappropriate analyses, assumptions or methodologies, and may cause the Company to estimate incorrectly future changes in the frequency or severity of claims. As a result, the Company could underprice risks, which would negatively affect the Company's margins, or it could overprice risks, which could reduce the Company's volume and competitiveness. In either event, the Company's financial condition, results of operations, and liquidity could be materially adversely affected.

The Company's insurance rates are subject to prior approval by the departments of insurance in most of the states in which the Company operates, and to political influences.

In most of the states in which it operates, the Company must obtain the DOI's prior approval of insurance rates charged to its customers, including any increases in those rates. If the Company is unable to receive approval of the rate changes it requests, or if such approval is delayed, the Company's ability to operate its business in a profitable manner may be limited and its financial condition, results of operations, and liquidity may be adversely affected. Additionally, in California, the law allows for consumer groups to intervene in rate filings, which frequently causes delays in the timeliness of rate approvals and implementation of rate changes and can impact the rate that is ultimately approved.

From time to time, the auto insurance industry comes under pressure from state regulators, legislators, and special interest groups to reduce, freeze, or set rates at levels that do not correspond with underlying costs, in the opinion of the Company's management. The homeowners insurance business faces similar pressure, particularly as regulators in catastrophe-prone states seek an acceptable methodology to price for catastrophe exposure. In addition, various insurance underwriting and pricing criteria regularly come under attack by regulators, legislators, and special interest groups. The result could be legislation, regulations, or new interpretations of existing regulations that adversely affect the Company's business, financial condition, and results of operations.

The effects of emerging claim and coverage issues on the Company's business are uncertain and may have an adverse effect on the Company's business.

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

Loss of, or significant restriction on, the use of credit scoring in the pricing and underwriting of personal lines products could reduce the Company's future profitability.

The Company uses credit scoring as a factor in pricing and underwriting decisions where allowed by state law. Some consumer groups and regulators have questioned whether the use of credit scoring unfairly discriminates against some groups of people and are seeking to prohibit or restrict the use of credit scoring in underwriting and pricing. Laws or regulations that significantly curtail or regulate the use of credit scoring, if enacted in a large number of states in which the Company operates, could negatively impact the Company's future results of operations.

If the Company cannot maintain its A.M. Best ratings, it may not be able to maintain premium volume in its insurance operations sufficient to attain the Company's financial performance goals.

The Company's ability to retain its existing business or to attract new business in its Insurance Companies is affected by its rating by A.M. Best Company. A.M. Best Company currently rates all of the Insurance Companies with sufficient operating history to be rated as either A+ (Superior) or A- (Excellent). If the Company is unable to maintain its A.M. Best ratings, the

Company may not be able to grow its premium volume sufficiently to attain its financial performance goals, and the result may adversely affect the Company's business, financial condition, and results of operations.

The Company may require additional capital in the future, which may not be available or may only be available on unfavorable terms.

The Company's future capital requirements depend on many factors, including its ability to underwrite new business successfully, its ability to establish premium rates and reserves at levels sufficient to cover losses, the success of its expansion plans and the performance of its investment portfolio. The Company may need to raise additional funds through equity or debt financing, sales of all or a portion of its investment portfolio or other assets. Any equity or debt financing, if available at all, may not be available on terms that are favorable to the Company. In the case of equity financing, the Company's shareholders could experience dilution. In addition, such securities may have rights, preferences, and privileges that are senior to those of the Company's current shareholders. If the Company cannot obtain adequate capital on favorable terms or at all, its business, financial condition, and results of operations could be adversely affected.

Funding for the Company's future growth may depend upon obtaining new financing, which may be difficult to obtain.

To accommodate the Company's expected future growth, the Company may require funding in addition to cash provided from current operations. The Company's ability to obtain financing may be constrained by economic conditions affecting global financial markets at the time the Company seeks additional financing. In addition, financial strength and claims-paying ability ratings have become an increasingly important factor in the Company's ability to access capital markets. Rating agencies assign ratings based upon an evaluation of an insurance company's ability to meet its financial obligations. The Company's current financial strength rating with Fitch is A. If the Company were to seek financing through the capital markets in the future, it may need to apply for Standard and Poor's and Moody's ratings. The ratings could limit the Company's access to the capital markets or adversely affect pricing of new debt sought in the capital markets. If the Company is unable to obtain necessary financing, it may be unable to take advantage of opportunities with potential business partners or new products or to otherwise expand its business as planned.

Changes in market interest rates or defaults may have an adverse effect on the Company's investment portfolio, which may adversely affect the Company's financial results.

The Company's financial results are affected, in part, by the performance of its investment portfolio. The Company's investment portfolio contains interest rate sensitive-investments, such as municipal and corporate bonds. Increases in market interest rates may have an adverse impact on the value of the investment portfolio by decreasing the value of fixed income securities. Declining market interest rates could have an adverse impact on the Company's investment income as it invests positive cash flows from operations and as it reinvests proceeds from maturing and called investments in new investments that could yield lower rates than the Company's investments have historically generated. Defaults in the Company's investment portfolio may produce operating losses and negatively impact the Company's results of operations.

Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions, and other factors beyond the Company's control. Market interest rates have been at historic lows for last several years as a result of government action and economic pressures from the recession in 2008 and 2009. Many observers, including the Company, believe that market interest rates will rise as the economy improves. Although the Company takes measures to manage the risks of investing in a changing interest rate environment, it may not be able to mitigate interest rate sensitivity effectively. The Company's mitigation efforts include maintaining a high quality portfolio and managing the duration of the portfolio to reduce the effect of interest rate changes. Despite its mitigation efforts, a significant change in interest rates could have a material adverse effect on the Company's financial condition and results of operations.

The Company's valuation of financial instruments may include methodologies, estimates, and assumptions that are subject to differing interpretations and could result in changes to valuations that may materially adversely affect the Company's financial condition or results of operations.

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 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 set 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 on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with the input used to measure their fair value and the level of market price observability.

During periods of market disruption, including periods of significantly changing interest rates, rapidly widening credit spreads, inactivity or illiquidity, it may be difficult to value certain of the Company's securities if trading becomes less frequent and/or market data become less observable. There may be certain asset classes in historically active markets with significant observable data that become illiquid due to changes in the financial environment. In such cases, the valuations associated with such securities may rely more on management judgment and include inputs and assumptions that are less observable or require greater estimation as well as valuation methods, which are more sophisticated or require greater estimation. The valuations generated by such methods may be different from the value at which the investments ultimately may be sold. Further, rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within the Company's consolidated financial statements, and the period-to-period changes in value could vary significantly. Decreases in value may have a material adverse effect on the Company's financial condition or results of operations.

Changes in the financial strength ratings of financial guaranty insurers issuing policies on bonds held in the Company's investment portfolio may have an adverse effect on the Company's investment results.

In an effort to enhance the bond rating applicable to certain bond issues, some bond issuers purchase municipal bond insurance policies from private insurers. The insurance generally guarantees the payment of principal and interest on a bond issue if the issuer defaults. By purchasing the insurance, the financial strength ratings applicable to the bonds are based on the credit worthiness of the insurer as well as the underlying credit of the bond issuer. These financial guaranty insurers are subject to DOI oversight. As the financial strength ratings of these insurers are reduced, the ratings of the insured bond issues correspondingly decrease. Although the Company has determined that the financial strength rating of the underlying bond issues in its investment portfolio are within the Company's investment policy without the enhancement provided by the insurance policies, any further downgrades in the financial strength ratings of these insurance companies or any defaults on the insurance policies written by these insurance companies may reduce the fair value of the underlying bond issues and the Company's investment portfolio or may reduce the investment results generated by the Company's investment portfolio, which could have a material adverse effect on the Company's financial condition, results of operations, and liquidity.

Deterioration of the municipal bond market in general or of specific municipal bonds held by the Company may result in a material adverse effect on the Company's financial condition, results of operations, and liquidity.

At December 31, 2013, 70.6% of the Company's total investment portfolio at fair value and 87.1% of its total fixed maturity investments at fair value were invested in tax-exempt municipal bonds. With such a large percentage of the Company's investment portfolio invested in municipal bonds, the performance of the Company's investment portfolio, including the cash flows generated by the investment portfolio is significantly dependent on the performance of municipal bonds. If the value of municipal bond markets in general or any of the Company's municipal bond holdings deteriorate, the performance of the Company's investment portfolio, financial condition, results of operations, and liquidity may be materially and adversely affected.

If the Company's loss reserves are inadequate, its business and financial position could be harmed.

The process of establishing property and liability loss reserves is inherently uncertain due to a number of factors, including underwriting quality, the frequency and amount of covered losses, variations in claims settlement practices, the costs and uncertainty of litigation, and expanding theories of liability. While the Company believes that its actuarial techniques and databases are sufficient to estimate loss reserves, the Company's approach may prove to be inadequate. If any of these contingencies, many of which are beyond the Company's control, results in loss reserves that are not sufficient to cover its actual losses, the Company's financial condition, results of operations, and liquidity may be materially adversely affected.

There is uncertainty involved in the availability of reinsurance and the collectability of reinsurance recoverable.

The Company reinsures a portion of its potential losses on the policies it issues to mitigate the volatility of the losses on its financial condition and results of operations. The availability and cost of reinsurance is subject to market conditions, which are outside of the Company's control. From time to time, market conditions have limited, and in some cases, prevented insurers from obtaining the types and amounts of reinsurance that they consider adequate for their business needs. As a result, the Company may not be able to successfully purchase reinsurance and transfer a portion of the Company's risk through reinsurance arrangements. In addition, as is customary, the Company initially pays all claims and seeks to recover the reinsured losses from its reinsurers. Although the Company reports as assets the amount of claims paid which the Company expects to recover from reinsurers, no assurance can be given that the Company will be able to collect from its reinsurers. If the amounts actually recoverable under the Company's reinsurance treaties are ultimately determined to be less than the amount it has reported as recoverable, the Company may incur a loss during the period in which that determination is made.

The failure of any of the loss limitation methods employed by the Company could have a material adverse effect on its financial condition or results of operations.

Various provisions of the Company's policies, such as limitations or exclusions from coverage which are intended to limit the Company's risks, may not be enforceable in the manner the Company intends. In addition, the Company's policies contain conditions requiring the prompt reporting of claims and the Company's right to decline coverage in the event of a violation of that condition. While the Company's insurance product exclusions and limitations reduce the Company's loss exposure and help eliminate known exposures to certain risks, it is possible that a court or regulatory authority could nullify or void an exclusion or legislation could be enacted modifying or barring the use of such endorsements and limitations in a way that would adversely affect the Company's loss experience, which could have a material adverse effect on its financial condition or results of operations.

The Company's business is vulnerable to significant catastrophic property loss, which could have an adverse effect on its financial condition and results of operations.

The Company faces a significant risk of loss in the ordinary course of its business for property damage resulting from natural disasters, man-made catastrophes and other catastrophic events, particularly hurricanes, earthquakes, hail storms, explosions, tropical storms, fires, sinkholes, war, acts of terrorism, severe weather and other natural and man-made disasters. Such events typically increase the frequency and severity of automobile and other property claims. Because catastrophic loss events are by their nature unpredictable, historical results of operations may not be indicative of future results of operations, and the occurrence of claims from catastrophic events may result in substantial volatility in the Company's financial condition and results of operations from period to period. Although the Company attempts to manage its exposure to such events, the occurrence of one or more major catastrophes in any given period could have a material and adverse impact on the Company's financial condition and results of operations and could result in substantial outflows of cash as losses are paid.

The Company depends on independent agents who may discontinue sales of its policies at any time.

The Company sells its insurance policies through approximately 8,300 independent agents. The Company must compete with other insurance carriers for these agents' business. Some competitors offer a larger variety of products, lower prices for insurance coverage, higher commissions, or more attractive non-cash incentives. To maintain its relationship with these independent agents, the Company must pay competitive commissions, be able to respond to their needs quickly and adequately, and create a consistently high level of customer satisfaction. If these independent agents find it preferable to do business with the Company's competitors, it would be difficult to renew the Company's existing business or attract new business. State regulations may also limit the manner in which the Company's producers are compensated or incentivized. Such developments could negatively impact the Company's relationship with these parties and ultimately reduce revenues.

The Company's expansion plans may adversely affect its future profitability.

The Company intends to continue to expand its operations in several of the states in which the Company has operations and into states in which it has not yet begun operations. The intended expansion will necessitate increased expenditures. The Company expects to fund these expenditures out of cash flow from operations. The expansion may not occur, or if it does occur, may not be successful in providing increased revenues or profitability. If the Company's cash flow from operations is insufficient to cover the increased costs of the expansion, or if the expansion does not provide the benefits anticipated, the Company's financial condition, results of operations, and ability to grow its business may be harmed.

Any inability of the Company to realize its deferred tax assets may have a material adverse effect on the Company's financial condition and results of operations.

The Company recognizes deferred tax assets and liabilities for the future tax consequences related to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for tax credits. The Company evaluates its deferred tax assets for recoverability based on available evidence, including assumptions about future profitability and capital gain generation. Although management believes that it is more likely than not that the deferred tax assets will be realized, some or all of the Company's deferred tax assets could expire unused if the Company is unable to generate taxable income of an appropriate character and in a sufficient amount to utilize these tax benefits in the future. Any determination that the Company would not be able to realize all or a portion of its deferred tax assets in the future would result in a charge to earnings in the period in which the determination is made. This charge could have a material adverse effect on the Company's results of operations and financial condition. In addition, the assumptions used to make this determination are subject to change from period-to-period based on changes in tax laws or variances between the Company's projected operating performance and actual results. As a result, significant management judgment is required in assessing the possible need for a deferred tax asset valuation allowance. For these reasons and because changes in these assumptions and estimates can materially affect the Company's results of operations and financial condition, management has included the assessment of a deferred tax asset valuation allowance as a critical accounting estimate.

The carrying value of the Company's goodwill and other intangible assets could be subject to an impairment write-down.

At December 31, 2013, the Company's consolidated balance sheets reflected approximately \$43 million of goodwill and \$42 million of other intangible assets. The Company evaluates whether events or circumstances have occurred that suggest that the fair values of its intangible assets are below their respective carrying values. The determination that the fair value of the Company's intangible assets is less than its carrying value may result in an impairment write-down. The impairment write-down would be reflected as expense and could have a material adverse effect on the Company's results of operations during the period in which it recognizes the expense. In the future, the Company may incur impairment charges related to the goodwill and other intangible assets already recorded or arising out of future acquisitions.

The Company relies on its information technology systems to manage many aspects of its business, and any failure of these systems to function properly or any interruption in their operation could result in a material adverse effect on the Company's business, financial condition, and results of operations.

The Company depends on the accuracy, reliability, and proper functioning of its information technology systems. The Company relies on these information technology systems to effectively manage many aspects of its business, including underwriting, policy acquisition, claims processing and handling, accounting, reserving and actuarial processes and policies, and to maintain its policyholder data. The Company is developing and deploying new information technology systems that are designed to manage many of these functions across all of the states in which it operates and all of the lines of insurance it offers. See "Overview—Technology" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." The failure of hardware or software that supports the Company's information technology systems, the loss of data contained in the systems, or any delay or failure in the full deployment of the Company's new information technology systems could disrupt its business and could result in decreased premiums, increased overhead costs, and inaccurate reporting, all of which could have a material adverse effect on the Company's business, financial condition, and results of operations.

In addition, despite system redundancy, the implementation of security measures, and the existence of a disaster recovery plan for the Company's information technology systems, these systems are vulnerable to damage or interruption from:

- earthquake, fire, flood and other natural disasters;
- terrorist attacks and attacks by computer viruses or hackers;
- power loss;
- unauthorized access; and
- computer systems, Internet, telecommunications or data network failure.

It is possible that a system failure, accident, or security breach could result in a material disruption to the Company's business. In addition, substantial costs may be incurred to remedy the damages caused by these disruptions. Following implementation of information technology systems, the Company may from time to time install new or upgraded business management systems. To the extent that a critical system fails or is not properly implemented and the failure cannot be corrected in a timely manner, the Company may experience disruptions to the business that could have a material adverse effect on the Company's results of operations.

Cyber security risks and the failure to maintain the confidentiality, integrity, and availability of internal or policyholder systems and data could result in damages to the Company's reputation and/or subject it to expenses, fines or lawsuits.

The Company collects and retains large volumes of internal and policyholder data, including personally identifiable information, for business purposes including underwriting, claims and billing purposes, and relies upon the various information technology systems that enter, process, summarize and report such data. The Company also maintains personally identifiable information about its employees. The confidentiality and protection of the Company's policyholder, employee and Company data are critical to the Company's business. The Company's policyholders and employees have a high expectation that it will adequately protect their personal information. The regulatory environment, as well as the requirements imposed by the payment card industry and insurance regulators, governing information, security and privacy laws is increasingly demanding and continues to evolve. Maintaining compliance with applicable information security and privacy regulations may increase the Company's operating costs and adversely impact its ability to market products and services to its policyholders. Furthermore, a penetrated or compromised information technology system or the intentional, unauthorized, inadvertent or negligent release or disclosure of data could result in theft, loss, fraudulent or unlawful use of policyholder, employee or Company data which could harm the Company's reputation or result in remedial and other expenses, fines or lawsuits.

Changes in accounting standards issued by the Financial Accounting Standards Board (“FASB”) or other standard-setting bodies may adversely affect the Company’s consolidated financial statements.

The Company’s consolidated financial statements are subject to the application of GAAP, which is periodically revised and/or expanded. Accordingly, the Company is required to adopt new or revised accounting standards from time to time issued by recognized authoritative bodies, including the FASB. It is possible that future changes the Company is required to adopt could change the current accounting treatment that the Company applies to its consolidated financial statements and that such changes could have a material effect on the Company’s financial condition and results of operations.

The Company may be required to adopt International Financial Reporting Standards (“IFRS”). The ultimate adoption of such standards could negatively impact its financial condition or results of operations.

Although not yet required, the Company could be required to adopt IFRS, which differs from GAAP, for the Company’s accounting and reporting standards. The ultimate implementation and adoption of new standards could materially impact the Company’s financial condition or results of operations.

The Company’s disclosure controls and procedures may not prevent or detect acts of fraud.

The Company’s disclosure controls and procedures are designed to reasonably assure that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to management and is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. The Company’s management, including its Chief Executive Officer and Chief Financial Officer, believe that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, the Company cannot provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been prevented or detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by an unauthorized override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and the Company cannot assure that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

Failure to maintain an effective system of internal control over financial reporting may have an adverse effect on the Company’s stock price.

Section 404 of the Sarbanes-Oxley Act of 2002, as amended, and the related rules and regulations promulgated by the SEC require the Company to include in its Annual Report on Form 10-K a report by its management regarding the effectiveness of the Company’s internal control over financial reporting. The report includes, among other things, an assessment of the effectiveness of the Company’s internal control over financial reporting as of the end of its fiscal year, including a statement as to whether or not the Company’s internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in the Company’s internal control over financial reporting identified by management. Areas of the Company’s internal control over financial reporting may require improvement from time to time. If management is unable to assert that the Company’s internal control over financial reporting is effective now or in any future period, or if the Company’s independent auditors are unable to express an opinion on the effectiveness of those internal controls, investors may lose confidence in the accuracy and completeness of the Company’s financial reports, which could have an adverse effect on the Company’s stock price.

The ability of the Company to attract, develop and retain talented employees, managers and executives, and to maintain appropriate staffing levels, is critical to the Company’s success.

The Company is constantly hiring and training new employees and seeking to retain current employees. An inability to attract, retain and motivate the necessary employees for the operation and expansion of the Company’s business could hinder its ability to conduct its business activities successfully, develop new products and attract customers.

The Company’s success also depends upon the continued contributions of its executive officers, both individually and as a group. The Company’s future performance will be substantially dependent on its ability to retain and motivate its management team. The loss of the services of any of the Company’s executive officers could prevent the Company from successfully implementing its business strategy, which could have a material adverse effect on the Company’s business, financial condition, and results of operations.

Challenging economic conditions may negatively affect the Company's business and operating results.

Challenging economic conditions could adversely affect the Company in the form of consumer behavior and pressure on its investment portfolio. Consumer behavior could include policy cancellations, modifications, or non-renewals, which may reduce cash flows from operations and investments, may harm the Company's financial position, and may reduce the Insurance Companies' statutory surplus. Challenging economic conditions also may impair the ability of the Company's customers to pay premiums as they become due, and as a result, the Company's bad debt reserves and write-offs could increase. It is also possible that claims fraud may increase. The Company's investment portfolios could be adversely affected as a result of financial and business conditions affecting the issuers of the securities in the Company's investment portfolio. In addition, declines in the Company's profitability could result in a charge to earnings for the impairment of goodwill, which would not affect the Company's cash flow but could decrease its earnings, and its stock price could be adversely affected.

The Company may be adversely affected if economic conditions result in either inflation or deflation. In an inflationary environment, established reserves may become inadequate and increase the Company's loss ratio, and market interest rates may rise and reduce the value of the Company's fixed maturity portfolio, while increasing interest expense on its LIBOR based debt. The DOIs may not approve premium rate increases in time for the Company to adequately mitigate inflated loss costs. In a deflationary environment, some fixed maturity issuers may have difficulty meeting their debt service obligations and thereby reduce the value of the Company's fixed maturity portfolio; equity investments may decrease in value; and policyholders may experience difficulties paying their premiums to the Company, which could adversely affect premium revenue.

The Company's business is vulnerable to significant losses related to sinkhole claims, which could have an adverse effect on its results of operations.

In 2011, the Company began its withdrawal from the Florida homeowners market due to the high incidence of sinkhole claims. While the Company has closed many sinkhole claims, and believes it has adequately reserved for the remaining open claims, it remains possible for legal or legislative action to require opening closed claims that could impair profitability. The Company completed its withdrawal from the Florida homeowners market in September 2012.

Risks Related to the Company's Industry

The private passenger automobile insurance industry is highly competitive, and the Company may not be able to compete effectively against larger or better-capitalized companies.

The Company competes with many property and casualty insurance companies selling private passenger automobile insurance in the states in which the Company operates. Many of these competitors are better capitalized than the Company, have higher A.M. Best ratings, and have a larger market share in the states in which the Company operates. The superior capitalization of the competitors may enable them to offer lower rates, to withstand larger losses, and to more effectively take advantage of new marketing opportunities. The Company's competition may also become increasingly better capitalized in the future as the traditional barriers between insurance companies and banks and other financial institutions erode and as the property and casualty industry continues to consolidate. The Company's ability to compete against these larger, better-capitalized competitors depends on its ability to deliver superior service and its strong relationships with independent agents.

The Company may undertake strategic marketing and operating initiatives to improve its competitive position and drive growth. If the Company is unable to successfully implement new strategic initiatives or if the Company's marketing campaigns do not attract new customers, the Company's competitive position may be harmed, which could adversely affect the Company's business and results of operations. Additionally, in the event of a failure of any competitor, the Company and other insurance companies would likely be required by state law to absorb the losses of the failed insurer and would be faced with an unexpected surge in new business from the failed insurer's former policyholders.

The Company may be adversely affected by changes in the private passenger automobile insurance industry.

79.1% of the Company's direct written premiums for the year ended December 31, 2013 were generated from private passenger automobile insurance policies. Adverse developments in the market for personal automobile insurance or the personal automobile insurance industry in general, whether related to changes in competition, pricing or regulations, could cause the Company's results of operations to suffer. The property-casualty insurance industry is also exposed to the risks of severe weather conditions, such as rainstorms, snowstorms, hail and ice storms, hurricanes, tornadoes, wild fires, sinkholes, earthquakes and, to a lesser degree, explosions, terrorist attacks, and riots. The automobile insurance business is also affected by cost trends that impact profitability. Factors which negatively affect cost trends include inflation in automobile repair costs, automobile parts costs, new and used car valuations, medical costs, and changes in non-economic costs due to changes in the legal and regulatory environments. In addition, the advent of driverless cars and usage-based insurance could materially alter the way that automobile insurance is marketed, priced, and underwritten.

The Company cannot predict the impact that changing climate conditions, including legal, regulatory and social responses thereto, may have on its business.

Various scientists, environmentalists, international organizations, regulators and other commentators believe that global climate change has added, and will continue to add, to the unpredictability, frequency and severity of natural disasters (including, but not limited to, hurricanes, tornadoes, freezes, droughts, other storms and fires) in certain parts of the world. In response, a number of legal and regulatory measures and social initiatives have been introduced in an effort to reduce greenhouse gas and other carbon emissions that may be chief contributors to global climate change. The Company cannot predict the impact that changing climate conditions, if any, will have on its business or its customers. It is also possible that the legal, regulatory and social responses to climate change could have a negative effect on the Company's results of operations or financial condition.

Changes in federal or state tax laws could adversely affect the Company's business, financial condition, results of operations, and liquidity.

The Company's financial condition, results of operations, and liquidity are dependent in part on tax policy implemented at the federal and/or state level. For example, a significant portion of the Company's investment portfolio consists of municipal securities that receive beneficial tax treatment under applicable federal tax law. The Company's results are also subject to federal and state tax rules applicable to dividends received from its subsidiaries and its equity holdings. Additionally, changes in tax laws could have an adverse effect on deferred tax assets and liabilities included in the Company's consolidated balance sheets and results of operations. The Company cannot predict whether any tax legislation will be enacted or whether any such changes to existing federal or state tax law would have a material adverse effect on the Company's financial condition and results of operations.

The insurance industry is subject to extensive regulation, which may affect the Company's ability to execute its business plan and grow its business.

The Company is subject to comprehensive regulation and supervision by government agencies in each of the states in which its Insurance Companies are domiciled, sell insurance products, issue policies, or manage claims. Some states impose restrictions or require prior regulatory approval of specific corporate actions, which may adversely affect the Company's ability to operate, innovate, obtain necessary rate adjustments in a timely manner or grow its business profitably. These regulations provide safeguards for policyholders and are not intended to protect the interests of shareholders. The Company's ability to comply with these laws and regulations, and to obtain necessary regulatory action in a timely manner is, and will continue to be, critical to its success. Some of these regulations include:

Required Licensing. The Company operates under licenses issued by the DOI in the states in which the Company sells insurance. If a regulatory authority denies or delays granting a new license, the Company's ability to enter that market quickly or offer new insurance products in that market may be substantially impaired. In addition, if the DOI in any state in which the Company currently operates suspends, non-renews, or revokes an existing license, the Company would not be able to offer affected products in the state.

Transactions Between Insurance Companies and Their Affiliates. Transactions between the Insurance Companies and their affiliates (including the Company) generally must be disclosed to state regulators, and prior approval of the applicable regulator is required before any material or extraordinary transaction may be consummated. State regulators may refuse to approve or delay approval of some transactions, which may adversely affect the Company's ability to innovate or operate efficiently.

Regulation of Insurance Rates and Approval of Policy Forms. The insurance laws of most states in which the Company conducts business require insurance companies to file insurance rate schedules and insurance policy forms for review and approval. If, as permitted in some states, the Company begins using new rates before they are approved, it may be required to issue refunds or credits to the Company's policyholders if the new rates are ultimately deemed excessive or unfair and disapproved by the applicable state regulator. In other states, prior approval of rate changes is required and there may be long delays in the approval process or the rates may not be approved. Accordingly, the Company's ability to respond to market developments or increased costs in that state can be adversely affected.

Restrictions on Cancellation, Non-Renewal or Withdrawal. Most of the states in which the Company operates have laws and regulations that limit its ability to exit a market. For example, these states may limit a private passenger auto insurer's ability to cancel and non-renew policies or they may prohibit the Company from withdrawing one or more lines of insurance business from the state unless prior approval is received from the state DOI. In some states, these regulations extend to significant reductions in the amount of insurance written, not only to a complete withdrawal. Laws and regulations that limit the Company's ability to cancel and non-renew policies in some states or locations and that subject withdrawal plans to prior approval requirements may restrict the Company's ability to exit unprofitable markets, which may harm its business and results of operations.

Other Regulations. The Company must also comply with regulations involving, among other matters:

- the use of non-public consumer information and related privacy issues;
- the use of credit history in underwriting and rating;
- limitations on the ability to charge policy fees;
- limitations on types and amounts of investments;
- the payment of dividends;
- the acquisition or disposition of an insurance company or of any company controlling an insurance company;
- involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;
- reporting with respect to financial condition;
- periodic financial and market conduct examinations performed by state insurance department examiners; and
- the other regulations discussed in this Annual Report on Form 10-K.

The failure to comply with these laws and regulations may also result in regulatory actions, fines and penalties, and in extreme cases, revocation of the Company's ability to do business in that jurisdiction. In addition, the Company may face individual and class action lawsuits by insured and other parties for alleged violations of certain of these laws or regulations.

In addition, from time to time, the Company may support or oppose legislation or other amendments to insurance regulations in California or other states in which it operates. Consequently, the Company may receive negative publicity related to its support or opposition of legislative or regulatory changes that may have a material adverse effect on the Company's financial condition, results of operations, and liquidity.

Regulation may become more extensive in the future, which may adversely affect the Company's business, financial condition, and results of operations.

No assurance can be given that states will not make existing insurance-related laws and regulations more restrictive in the future or enact new restrictive laws. New or more restrictive regulation in any state in which the Company conducts business could make it more expensive for it to continue to conduct business in these states, restrict the premiums the Company is able to charge or otherwise change the way the Company does business. In such events, the Company may seek to reduce its writings in or to withdraw entirely from these states. In addition, from time to time, the United States Congress and certain federal agencies investigate the current condition of the insurance industry to determine whether federal regulation is necessary. The Company cannot predict whether and to what extent new laws and regulations that would affect its business will be adopted, the timing of any such adoption and what effects, if any, they may have on the Company's business, financial condition, and results of operations.

Assessments and other surcharges for guaranty funds, second-injury funds, catastrophe funds, and other mandatory pooling arrangements may reduce the Company's profitability.

Virtually all states require insurers licensed to do business in their state to bear a portion of the loss suffered by some insured parties as the result of impaired or insolvent insurance companies. Many states also have laws that established second-injury funds to provide compensation to injured employees for aggravation of a prior condition or injury which are funded by either assessments based on paid losses or premium surcharge mechanisms. In addition, as a condition to the ability to conduct business in various states, the Insurance Companies must participate in mandatory property and casualty shared market mechanisms or pooling arrangements, which provide various types of insurance coverage to individuals or other entities that otherwise are unable to purchase that coverage from private insurers. The effect of these assessments and mandatory shared-market mechanisms or changes in them could reduce the Company's profitability in any given period or limit its ability to grow its business.

The insurance industry faces litigation risks, which, if resolved unfavorably, could result in substantial penalties and/or monetary damages, including punitive damages. In addition, insurance companies incur material expenses defending litigation and their results of operations or financial condition could be adversely affected if they fail to accurately project litigation expenses.

Insurance companies are subject to a variety of legal actions including breach of contract claims, tort claims, fraud and misrepresentation claims, employee benefit claims, and wage and hour claims. In addition, insurance companies incur and likely will continue to incur potential liability for claims related to the insurance industry in general and to the Company's business in

particular, such as those related to allegations for failure to pay claims, termination or non-renewal of coverage, interpretation of policy language, policy sales practices, reinsurance matters, and other similar matters. Such actions can also include allegations of fraud, misrepresentation, and unfair or improper business practices and can include claims for punitive damages.

Court decisions and legislative activity may increase exposures for any of the types of claims insurance companies face. There is a risk that insurance companies could incur substantial legal fees and expenses in any of the actions companies defend in excess of amounts budgeted for defense.

The Company and the Insurance Companies are named as defendants in a number of lawsuits. Those that management believes could have a material effect on the Company's consolidated financial statements are described more fully at "Overview —B. Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 16 of Notes to Consolidated Financial Statements. Litigation, by its very nature, is unpredictable and the outcome of these cases is uncertain. The precise nature of the relief that may be sought or granted in any lawsuit is uncertain and may negatively impact the manner in which the Company conducts its business and results of operations, which could materially increase the Company's legal expenses. In addition, potential litigation involving new claim, coverage, and business practice issues could adversely affect the Company's business by changing the way policies are priced, extending coverage beyond its underwriting intent, or increasing the size of claims.

Risks Related to the Company's Stock

The Company is controlled by small number of shareholders who will be able to exert significant influence over matters requiring shareholder approval, including change of control transactions.

George Joseph and Gloria Joseph collectively own more than 50% of the Company's common stock. Accordingly, George Joseph and Gloria Joseph have the ability to exert significant influence on the actions the Company may take in the future, including change of control transactions. This concentration of ownership may conflict with the interests of the Company's other shareholders and lenders.

Future sales of common stock may affect the market price of the Company's common stock and the future exercise of options and warrants will result in dilution to the Company's shareholders.

The Company may raise capital in the future through the issuance and sale of shares of its common stock. The Company cannot predict what effect, if any, such future sales will have on the market price of its common stock. Sales of substantial amounts of its common stock in the public market could adversely affect the market price of the Company's outstanding common stock, and may make it more difficult for shareholders to sell common stock at a time and price that the shareholder deems appropriate. In addition, the Company has issued options to purchase shares of its common stock. In the event that any options to purchase common stock are exercised, shareholders will suffer dilution in their investment.

Applicable insurance laws may make it difficult to effect a change of control of the Company or the sale of any of its Insurance Companies.

Before a person can acquire control of a U.S. insurance company or any holding company of a U.S. insurance company, prior written approval must be obtained from the DOI of the state where the insurer is domiciled. Prior to granting approval of an application to acquire control of the insurer or holding company, the state DOI will consider a number of factors relating to the acquirer and the transaction. These laws and regulations may discourage potential acquisition proposals and may delay, deter or prevent a change of control of the Company or the sale by the Company of any of its Insurance Companies, including transactions that some or all of the Company's shareholders might consider to be desirable.

Although the Company has consistently paid cash dividends in the past, it may not be able to pay cash dividends in the future.

The Company has consistently paid cash dividends since the public offering of its common stock in November 1985. However, future cash dividends will depend upon a variety of factors, including the Company's profitability, financial condition, capital needs, future prospects, and other factors deemed relevant by the Board of Directors. The Company's ability to pay dividends may also be limited by the ability of the Insurance Companies to make distributions to the Company, which may be restricted by financial, regulatory or tax constraints, and by the terms of the Company's debt instruments. In addition, there can be no assurance that the Company will continue to pay dividends even if the necessary financial and regulatory conditions are met and if sufficient cash is available for distribution.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company owns the following buildings which are mostly occupied by the Company's employees. Space not occupied by the Company is leased to independent third party tenants.

Location	Purpose	Size in square feet	Percent occupied by the Company at December 31, 2013
Brea, CA	Home office and I.T. facilities (2 buildings)	236,000	100%
Folsom, CA	Administrative and Data Center	88,000	100%
Los Angeles, CA	Executive offices	41,000	95%
Rancho Cucamonga, CA	Administrative	127,000	100%
Clearwater, FL	Administrative	157,000	82%
Oklahoma City, OK	Administrative	100,000	19%

The Company leases additional office space for operations. Office location is not crucial to the Company's operations, and the Company anticipates no difficulty in extending these leases or obtaining comparable office space. For future expansion, the Company owns 6.3-acre and 5.9-acre parcels of land in Brea and Rancho Cucamonga, California, respectively.

The Company's properties are well maintained, adequately meet its needs, and are being utilized for their intended purposes.

Item 3. 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 "Critical Accounting Policies and Estimates" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 1 of Notes to Consolidated Financial Statements.

The Company also 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, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see "Overview—B. Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 16 of Notes to Consolidated Financial Statements, which is incorporated herein by reference.

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

Item 4. Mine Safety Disclosure

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

The following table presents the high and low sales price per share on the New York Stock Exchange (symbol: MCY) since January 2012.

<u>2013</u>	<u>High</u>	<u>Low</u>
1st Quarter	\$ 40.90	\$ 36.03
2nd Quarter	\$ 46.98	\$ 37.58
3rd Quarter	\$ 48.50	\$ 43.08
4th Quarter	\$ 51.00	\$ 46.00
<u>2012</u>	<u>High</u>	<u>Low</u>
1st Quarter	\$ 46.76	\$ 42.65
2nd Quarter	\$ 46.04	\$ 41.00
3rd Quarter	\$ 42.32	\$ 36.01
4th Quarter	\$ 43.21	\$ 38.21

The closing price of the Company's common stock on February 3, 2014 was \$43.59.

Holders

As of February 3, 2014, there were approximately 133 holders of record of the Company's common stock.

Dividends

Since the public offering of its common stock in November 1985, the Company has paid regular quarterly dividends on its common stock. During 2013 and 2012, the Company paid dividends on its common stock of \$2.4525 and \$2.4425 per share, respectively. On February 7, 2014, the Board of Directors declared a \$0.6150 quarterly dividend payable on March 31, 2014 to shareholders of record on March 17, 2014.

For financial statement purposes, the Company records dividends on the declaration date. The Company expects to continue paying quarterly dividends; however, the continued payment and amount of cash dividends will depend upon the Company's operating results, overall financial condition, capital requirements, and general business conditions.

Holding Company Act

The California Companies are subject to California DOI regulation pursuant to the provisions of the Holding Company Act. The Holding Company Act requires disclosure of any material transactions among affiliates within a Holding Company System. Certain transactions and dividends defined to be of an "extraordinary" type may not occur if the California DOI disapproves the transaction within 30 days after notice. An extraordinary dividend is a dividend which, together with other dividends or distributions made within the preceding 12 months, exceeds the greater of 10% of the insurance company's statutory policyholders' surplus as of the preceding December 31 or the insurance company's statutory net income for the preceding calendar year.

The Insurance Companies are required to notify the California DOI of any dividend after declaration, but prior to payment. There are similar limitations imposed by other states on the Insurance Companies' ability to pay dividends. As of December 31, 2013, the Insurance Companies are permitted to pay in 2014, without obtaining DOI approval for extraordinary dividends, \$260.2 million in dividends to Mercury General, of which \$238.1 million may be paid by the California Companies.

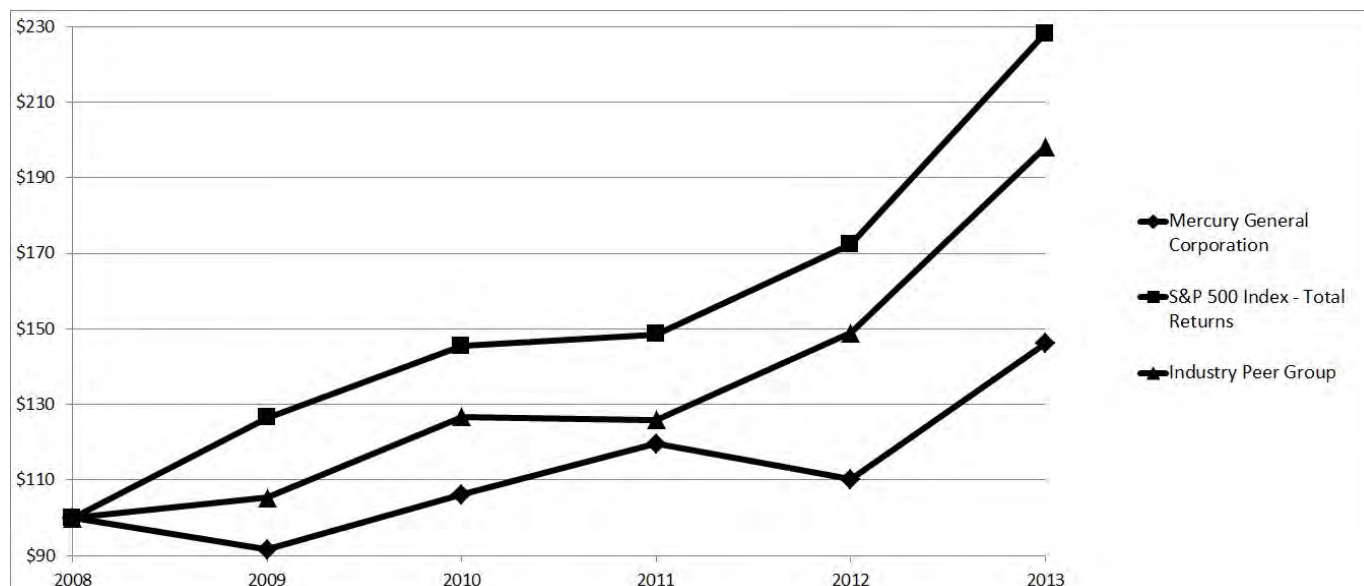
For a discussion of certain restrictions on the payment of dividends to Mercury General by some of its insurance subsidiaries, see Note 11 of Notes to Consolidated Financial Statements.

Performance Graph

The following graph compares the cumulative total shareholder returns on the Company's Common Stock (Symbol: MCY) with the cumulative total returns on the Standard and Poor's 500 Composite Stock Price Index ("S&P 500 Index") and the Company's

industry peer group over the last five years. The graph assumes that \$100 was invested on December 31, 2008 in each of the Company's Common Stock, the S&P 500 Index and the industry peer group and the reinvestment of all dividends.

Comparative Five-Year Cumulative Total Returns Stock Price Plus Reinvested Dividends



	2008	2009	2010	2011	2012	2013
Mercury General	\$ 100.00	\$ 91.67	\$ 106.21	\$ 119.59	\$ 110.22	\$ 146.10
Industry Peer Group	100.00	105.30	126.71	125.95	148.98	198.15
S&P 500 Index	100.00	126.46	145.51	148.59	172.37	228.19

The industry peer group consists of Ace Limited, Alleghany Corporation, Allstate Corporation, American Financial Group, Berkshire Hathaway, Chubb Corporation, Cincinnati Financial Corporation, CNA Financial Corporation, Erie Indemnity Company, Hanover Insurance Group, HCC Insurance Holdings, Markel Corporation, Old Republic International, Progressive Corporation, RLI Corporation, Selective Insurance Group, Travelers Companies, Inc., W.R. Berkley Corporation and XL Capital, Ltd.

Recent Sales of Unregistered Securities

None.

Share Repurchases

The Company has had a stock repurchase program since 1998. The Company's Board of Directors authorized a \$200 million stock repurchase on July 26, 2013, and the authorization will expire in July 2014. The Company may repurchase shares of its common stock under the program in open market transactions at the discretion of management. The Company will use dividends received from the Insurance Companies to fund the share repurchases. Since the inception of the program, the Company has purchased and retired 1,266,100 shares of common stock at an average price of \$31.36. No stock has been purchased since 2000.

Item 6. Selected Financial Data

The following selected financial and operating data are derived from the Company's audited consolidated financial statements. The selected financial and operating data should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and notes thereto contained elsewhere in this Annual Report on Form 10-K.

	Year Ended December 31,				
	2013	2012	2011	2010	2009
	(Amounts in thousands, except per share data)				
Income Data:					
Net premiums earned	\$ 2,698,187	\$ 2,574,920	\$ 2,566,057	\$ 2,566,685	\$ 2,625,133
Net investment income	124,538	131,896	140,947	143,814	144,949
Net realized investment (losses) gains	(11,422)	66,380	58,397	57,089	346,444
Other	9,738	10,174	11,884	8,297	4,967
Total revenues	2,821,041	2,783,370	2,777,285	2,775,885	3,121,493
Losses and loss adjustment expenses	1,962,690	1,961,448	1,829,205	1,825,766	1,782,233
Policy acquisition costs	505,517	477,788	481,721	505,565	543,307
Other operating expenses	219,478	207,281	215,711	255,358	217,683
Interest	1,260	1,543	5,549	6,806	6,729
Total expenses	2,688,945	2,648,060	2,532,186	2,593,495	2,549,952
Income before income taxes	132,096	135,310	245,099	182,390	571,541
Income tax expense	19,953	18,399	53,935	30,192	168,469
Net income	\$ 112,143	\$ 116,911	\$ 191,164	\$ 152,198	\$ 403,072
Per Share Data:					
Basic earnings per share	\$ 2.04	\$ 2.13	\$ 3.49	\$ 2.78	\$ 7.36
Diluted earnings per share	\$ 2.04	\$ 2.13	\$ 3.49	\$ 2.78	\$ 7.32
Dividends paid	\$ 2.4525	\$ 2.4425	\$ 2.41	\$ 2.37	\$ 2.33

	December 31,				
	2013	2012	2011	2010	2009
	(Amounts in thousands, except per share data)				
Balance Sheet Data:					
Total investments	\$ 3,158,312	\$ 3,180,095	\$ 3,062,421	\$ 3,155,257	\$ 3,146,857
Total assets	4,315,181	4,189,686	4,070,006	4,203,364	4,232,633
Losses and loss adjustment expenses	1,038,984	1,036,123	985,279	1,034,205	1,053,334
Unearned premiums	953,527	920,429	843,427	833,379	844,540
Notes payable	190,000	140,000	140,000	267,210	271,397
Shareholders' equity	1,822,486	1,842,497	1,857,483	1,794,815	1,770,946
Book value per share	33.15	33.55	33.86	32.75	32.33

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statements

Certain statements in this Annual Report on Form 10-K or in other materials the Company has filed or will file with the SEC (as well as information included in oral statements or other written statements made or to be made by the Company) contain or may contain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may address, among other things, the Company's strategy for growth, business development, regulatory approvals, market position, expenditures, financial results, and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company's actual business, prospects, and results of operations to differ materially from the historical information contained in this Annual Report on Form 10-K and from those that may be expressed or implied by the forward-looking statements contained in this Annual Report on Form 10-K and in other reports or public statements made by the Company.

Factors that could cause or contribute to such differences include, among others: the competition currently existing in the automobile insurance markets in California and the other states in which the Company operates; the cyclical and generally competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserves or other estimates; the accuracy and adequacy of the Company's pricing methodologies; the Company's success in managing its non-California business; the impact of potential third party "bad-faith" legislation, changes in laws, regulations or new interpretations of existing laws and regulations, tax position challenges by the California Franchise Tax Board ("FTB"), and decisions of courts, regulators and governmental bodies, particularly in California; the Company's ability to obtain and the timing of required regulatory approvals of premium rate changes for insurance policies issued in states where the Company operates; the Company's reliance on independent agents to market and distribute its policies; the investment yields the Company is able to obtain on its investments and the market risks associated with the Company's investment portfolio; the effect government policies may have on market interest rates; uncertainties related to assumptions and projections generally, inflation and changes in economic conditions; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions, trends in litigation, and health care and auto repair costs; adverse weather conditions or natural disasters, including those which may be related to climate change, in the markets served by the Company; the stability of the Company's information technology systems and the ability of the Company to execute on its information technology initiatives; the Company's ability to realize deferred tax assets or to hold certain securities with current loss positions to recovery or maturity; and other risks and uncertainties, including but not limited to those discussed in "Risk Factors" in Item 1A of this Annual Report on Form 10-K or that are otherwise described or updated from time to time in the Company's SEC filings, all of which are difficult to predict and many of which are beyond the Company's control. GAAP prescribes when a Company may reserve for particular risks including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods.

From time to time, forward-looking statements are also included in the Company's quarterly reports on Form 10-Q and current reports on Form 8-K, in press releases, in presentations, on its web site, and in other materials released to the public. The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K or, in the case of any document the Company incorporates by reference, any other report filed with the SEC or any other public statement made by the Company, the date of the document, report or statement. Investors should also understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company's forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements.

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 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 large impact on the Company's ability to grow and retain business.

The Company is headquartered in Los Angeles, California and operates primarily as a personal automobile insurer selling policies through a network of independent agents in thirteen states: Arizona, California, Florida, Georgia, Illinois, Michigan, Nevada, New Jersey, New York, Oklahoma, Pennsylvania, Texas, and Virginia. The Company also offers homeowners, commercial automobile, commercial property, mechanical breakdown, fire, and umbrella insurance. Private passenger automobile lines of insurance accounted for 79.1% of the \$2.7 billion of the Company's direct premiums written in 2013. 81.3% of the private passenger automobile premiums were written in California.

The Company expects to continue its growth by expanding into new states in the future to achieve greater geographic diversification. There are challenges and risks involved in entering each new state, including establishing adequate rates without any operating history in the state, working with a new regulatory regime, hiring and training competent personnel, building adequate systems, and finding qualified agents to represent the Company. The Company does not expect to enter into any new states during 2014.

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 Annual Report on Form 10-K.

2013 Financial Performance Summary

The Company's net income for the year ended December 31, 2013 decreased to \$112.1 million, or \$2.04 per diluted share, from \$116.9 million, or \$2.13 per diluted share, for the same period in 2012. Approximately \$125 million in pre-tax investment income was generated during 2013 on a portfolio of approximately \$3.2 billion at fair value at December 31, 2013, compared to \$132 million pre-tax investment income during 2012 on a portfolio of approximately \$3.2 billion at fair value at December 31, 2012. Included in net income are net realized investment losses of \$11.4 million and gains of \$66.4 million in 2013 and 2012, respectively.

During 2013, the Company continued its marketing efforts to enhance name recognition and lead generation. The Company believes that its marketing efforts, combined with its ability to maintain relatively low prices and a strong reputation, make the Company very competitive in California and in other states.

The Company believes its thorough underwriting process gives it an advantage over competitors. The Company's agent relationships and underwriting and claims processes are its most important competitive advantages.

The Company's operating results and growth have allowed it to consistently generate positive cash flow from operations, which was approximately \$210 million and \$148 million in 2013 and 2012, respectively. Cash flow from operations has been used to pay shareholder dividends and help support growth.

Economic and Industry Wide Factors

- Regulatory Uncertainty—The insurance industry is subject to strict state regulation and oversight and is governed by the laws of each state in which each insurance company operates. State regulators generally have substantial power and authority over insurance companies including, in some states, approving rate changes and rating factors, and establishing minimum capital and surplus requirements. In many states, insurance commissioners may emphasize different agendas or interpret existing regulations differently than previous commissioners. There is no certainty that current or future regulations and the interpretation of those regulations by insurance commissioners and the courts will not have an adverse impact on the Company.
- Cost Uncertainty—Because insurance companies pay claims after premiums are collected, the ultimate cost of an insurance policy is not known until well after the policy revenues are earned. Consequently, significant assumptions are made when establishing insurance rates and loss reserves. While insurance companies use sophisticated models and experienced actuaries to assist in setting rates and establishing loss reserves, there can be no assurance that current rates or current reserve estimates will be adequate. Furthermore, there can be no assurance that insurance regulators will approve rate increases when the Company's actuarial analysis indicate that they are needed.
- Economic Conditions—Many businesses are still experiencing a slow recovery from the severe economic recession. Though optimism is growing, economists and analysts expect that the global recovery will remain modest and uneven in 2014 due in large part to continuing political disagreements in Washington that may cause businesses and consumers

to limit spending. Further, softness in the European banking sector and the Japanese fiscal condition continue to lead to weaker global economic growth, heightened financial vulnerabilities and some negative rating actions. The Company is unable to predict the duration and severity of current global economic conditions and their impact on the United States, and California, where the majority of the Company's business is produced. If economic conditions do not show improvement, there could be an adverse impact on the Company's financial condition, results of operations, and liquidity.

- Inflation—The largest cost component for automobile insurers is losses, which include medical costs, replacement automobile parts, and labor costs. There can be significant variation in the overall increases in medical cost inflation, and it is often a year or more after the respective fiscal period ends before sufficient claims have closed for the inflation rate to be known with a reasonable degree of certainty. Therefore, it can be difficult to establish reserves and set premium rates, particularly when actual inflation rates may be higher or lower than anticipated.
- Loss Frequency—Another component of overall loss costs is loss frequency, which is the number of claims per risk insured. There has been a long-term trend of declining loss frequency in the personal automobile insurance industry. However, in recent years, the trend has shown increasing loss frequency, and the Company may not be able to accurately predict the trend of loss frequency in the future.
- Underwriting Cycle and Competition—The property and casualty insurance industry is highly cyclical, with alternating hard and soft market conditions. The Company has historically seen significant premium growth during hard markets. The Company believes that the market is mixed with carriers both raising and decreasing rates depending on individual state profitability and the carriers' growth appetite.

Technology

Agency systems

In 2013, the Company continued to invest in its web-based agency systems by adding new capabilities and enhanced features such as improved motor vehicle and accident matching and reconciliation. Many agents use comparative raters to evaluate products and prices from different insurance carriers, and the Company has completed integrations with the most popular raters for the private passenger automobile and homeowner lines of business.

A new commission system is anticipated to be released in 2014 that will enhance the efficiency and flexibility of the current commission calculation and payment process.

Customer systems

Customer web capability was expanded in 2013 and allows customers in California, Georgia, and Nevada to bind and pay for new private passenger automobile policies on-line.

Operations systems

Guidewire, a commercially available software solution, was launched in 2010 to replace legacy platforms. As of December 31, 2013, Guidewire for homeowners has been deployed in nine of the Company's states, for commercial automobile in ten states including California, and for personal automobile in five states. In the next two years, the Company plans to implement Guidewire for California homeowners and private passenger automobile claims processing.

B. Regulatory and Legal Matters

The process for implementing rate changes varies by state. Insurance rates in California, Georgia, New York, New Jersey, Pennsylvania, and Nevada require prior approval from the state DOI while insurance rates in Illinois, Texas, Virginia, Arizona, and Michigan must only be filed with the state DOI before they are implemented. Oklahoma and Florida have a modified version of prior approval laws. In all states, the insurance code provides that rates must not be excessive, inadequate, or unfairly discriminatory. For the Company's two largest lines of business, private passenger automobile and homeowners, the Company filed rate increases in thirteen states during 2013.

The California DOI uses rating factor regulations requiring automobile insurance rates to be determined in decreasing order of importance by (1) driving safety record, (2) miles driven per year, (3) years of driving experience, and (4) other factors as determined by the California DOI to have a substantial relationship to the risk of loss and adopted by regulation.

The Company filed for a 3.9% rate increase for its California homeowners line of business in May 2009. After a rate hearing by an ALJ, the Company was ordered by the California Insurance Commissioner to reduce rates by 5.5%. The rate reduction was implemented during the second quarter of 2013. The Company subsequently filed for a rate increase that contained more recent

data, and an 8.26% rate increase was approved by the California Insurance Commissioner. The rate increase went into effect in January 2014. In addition, the Company is challenging some of the issues in Superior Court that were raised by the ALJ in the rate hearing.

In January 2013, the California DOI approved an auto body repair regulation intended to strengthen consumer protection. This regulation requires insurers to settle automobile insurance claims using repair standards described by the regulation and not by the insurers' own standards. The new ruling became effective in March 2013. While the impact of the new ruling was minimal during 2013, it may increase the cost of parts for auto repairs in the future.

In April 2010, the California DOI issued a Notice of Non-Compliance ("2010 NNC") to MIC, MCC, and CAIC based on a Report of Examination of the Rating and Underwriting Practices of these companies issued by the California DOI in February 2010. The 2010 NNC includes allegations of 35 instances of noncompliance with applicable California insurance law and seeks to require that each of MIC, MCC, and CAIC change its rating and underwriting practices to rectify the alleged noncompliance and may also seek monetary penalties. In April 2010, the Company submitted a Statement of Compliance and Notice of Defense to the 2010 NNC, in which it denied the allegations contained in the 2010 NNC and provided specific defenses to each allegation. The Company also requested a hearing in the event that the Statement of Compliance and Notice of Defense does not establish to the satisfaction of the California DOI that the alleged noncompliance does not exist, and the matters described in the 2010 NNC are not otherwise able to be resolved informally with the California DOI. However, no assurance can be given that efforts to resolve the 2010 NNC informally will be successful.

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 seeks to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker fee and 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 ALJ bifurcated the 2004 NNC between (a) the California DOI's order to show cause, in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance, in which the California DOI asserts the unlawful rate allegations. In February 2012, the ALJ submitted a proposed decision dismissing the California DOI's 2004 NNC. In March 2012, the California Insurance Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Superior Court in April 2012. Following a hearing, the Superior Court sustained the California Insurance Commissioner's demurrer without leave to amend because it found the Company must first exhaust its administrative remedies. In January 2013, the Superior Court's decision was subsequently affirmed on appeal. In January 2013, the ALJ heard various pending motions that had been filed by the Company in June 2011. The ALJ granted certain portions of the California DOI's motion for collateral estoppel to prevent the Company from litigating certain findings of fact reached in a prior litigation action and denied the Company's motion for governmental estoppel and laches, without prejudice, on the ground that a resolution of the motion requires specific factual findings in the context of the evidentiary hearing. The ALJ held an evidentiary hearing on the noncompliance portion of the 2004 NNC during April 2013. A mediation was held in September 2013, but the parties were unable to reach a settlement of the matter. Post-hearing briefs have been filed by the Company, the California DOI, and a consumer group. Until the evidentiary record is closed, there is no set timetable for a decision by the ALJ or, thereafter, a decision by the California Insurance Commissioner.

The Company denies the allegations in the 2004 and 2010 NNC matters, and believes that no monetary penalties are warranted, and the Company intends to defend itself against the allegations vigorously. The Company has been subject to fines and penalties by the California DOI in the past due to alleged violations of the California Insurance Code. The largest and most recent of these was settled in 2008 for \$300,000. However, prior settlement amounts are not necessarily indicative of the potential results in the current notice of non-compliance matters. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the 2004 and 2010 NNC matters will be material to the Company's financial position, results of operations, or cash flow. The Company has accrued a liability for the estimated cost to defend itself in the notice of non-compliance matters.

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 "Critical Accounting Policies and Estimates" and Note 1 of Notes to Consolidated Financial Statements.

The Company also 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, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see Note 16 of Notes to Consolidated Financial Statements—Commitments and Contingencies—Litigation.

C. Critical Accounting Policies and Estimates

Reserves

Preparation of the Company's consolidated financial statements requires 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 reserve that is required. Changes in the regulatory and legal environment, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact ultimate claim costs. 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 estimates for loss reserves. This uncertainty comes from many factors which may include changes in claims reporting and settlement patterns, changes in the regulatory or legal environment, 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 reserve by looking at historical patterns and trends and projecting these out to current reserves. The underlying factors and assumptions that serve as the basis for preparing the 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 an independent actuarial consultant to review the Company's reserves and to provide the annual actuarial opinions required under state statutory accounting requirements. The Company does not rely on the actuarial consultant for GAAP reporting or periodic report disclosure purposes. The Company analyzes loss reserves quarterly primarily using the incurred loss, claim count development, and average severity methods described below. The Company also uses the paid loss development method as part of its reserve analysis. 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 business or coverage within a line of business. When establishing the 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.

- The *incurred loss development 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 development method* provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of business which have a long operating history.
- 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* provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing reserves. 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 *paid loss development method* analyzes historical payment patterns to estimate the amount of losses yet to be paid. The Company uses this method for losses and loss adjustment expenses.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on reserves established by adjusters and average losses on previous similar catastrophes.

There are many factors that can cause variability between the ultimate expected loss and the actual developed loss. While there are certainly other factors, the Company believes that the following three items tend to create the most variability between expected losses and actual losses.

(1) Inflation

For the Company's California automobile lines of business, total reserves are comprised of the following:

- BI reserves—approximately 60% of total reserves
- Material damage (MD) reserves, including collision and comprehensive property damage—approximately 20% of total reserves
- Loss adjustment expenses reserves—approximately 20% of total reserves.

Loss development on MD reserves is generally insignificant because MD claims are generally settled in a shorter period than BI claims. The majority of the loss adjustment expense reserves are estimated costs to defend BI claims, which tend to require longer periods of time to settle as compared to MD claims.

BI loss reserves are generally the most difficult to estimate because they take longer to close than other coverages. BI coverage in the Company's policies includes injuries sustained by any person other than the insured, except in the case of uninsured or underinsured motorist BI coverage, which covers damages to the insured for BI caused by uninsured or underinsured motorists. BI payments are primarily for medical costs and general damages.

The following table presents the typical closure patterns of BI claims in the California automobile insurance coverage:

	% of Total	
	Claims Closed	Dollars Paid
BI claims closed in the accident year reported	42%	14%
BI claims closed one year after the accident year reported	80%	55%
BI claims closed two years after the accident year reported	94%	81%
BI claims closed three years after the accident year reported	99%	95%

BI claims closed in the accident year reported are generally the smaller and less complex claims that settle for approximately \$3,000 to \$3,500, on average, whereas the total average settlement, once all claims are closed in a particular accident year, is approximately \$8,500 to \$10,000. The Company creates incurred and paid loss triangles to estimate ultimate losses utilizing historical payment and reserving patterns and evaluates the results of this analysis against its frequency and severity analysis to establish BI reserves. The Company adjusts development factors to account for inflation trends it sees in loss severity. As a larger proportion of claims from an accident year are settled, there becomes a higher degree of certainty for the reserves established for that accident year. Consequently, there is a decreasing likelihood of reserve development on any particular accident year, as those periods age. At December 31, 2013, the Company believes that the accident years that are most likely to develop are the 2011 through 2013 accident years; however, it is possible that older accident years could develop as well.

In general, the Company expects that historical claims trends will continue with costs tending to increase, which is generally consistent with historical data, and therefore the Company believes that it is reasonable to expect inflation to continue. The Company is experiencing inflation at a rate that is higher than in recent years. Many potential factors can affect the BI inflation rate, including changes in claims handling process, statutes and regulations, the number of litigated files, increased use of medical procedures such as MRIs and epidural injections, general economic factors, timeliness of claims adjudication, vehicle safety, weather patterns, and gasoline prices, among other factors; however, the magnitude of such impact on the inflation rate is unknown.

The Company believes that it is reasonably possible that the California automobile BI severity could vary from recorded amounts by as much as 10%, 5%, and 3% for 2013, 2012, and 2011, respectively. For example, at December 31, 2013, the loss severity for the amounts recorded at December 31, 2012 changed by (2.2)%, 2.1%, and 1.4% for the 2012, 2011, and 2010 accident years, respectively. Comparatively, at December 31, 2012, the loss severity for the amounts recorded at December 31, 2011 increased by 7.0%, 2.5%, and 0.3% for the 2011, 2010, and 2009 accident years, respectively. The following table presents the effects on the 2013, 2012, and 2011 accident year California BI loss reserves based on possible variations in the severity recorded; however, the variation could be more or less than these amounts.

California Bodily Injury Inflation Reserve Sensitivity Analysis

Accident Year	Number of Claims Expected	Actual Recorded Severity at 12/31/13	Implied Inflation Rate Recorded ⁽¹⁾	(A) Pro-forma severity if actual severity is lower by 10% for 2013, 5% for 2012, and 3% for 2011	(B) Pro-forma severity if actual severity is higher by 10% for 2013, 5% for 2012, and 3% for 2011	Favorable loss development if actual severity is less than recorded (Column A)	Unfavorable loss development if actual severity is more than recorded (Column B)
2013	29,369	\$ 10,418	6.6%	\$ 9,376	\$ 11,460	\$ 30,602,000	\$ (30,602,000)
2012	28,016	\$ 9,774	5.8%	\$ 9,285	\$ 10,263	\$ 13,700,000	\$ (13,700,000)
2011	27,095	\$ 9,234	3.0%	\$ 8,957	\$ 9,511	\$ 7,505,000	\$ (7,505,000)
2010	27,076	\$ 8,968	—	—	—	—	—
Total Loss Development—Favorable (Unfavorable)						\$ 51,807,000	\$ (51,807,000)

- (1) Implied inflation rate is calculated by dividing the difference between current and prior year actual recorded severity by the prior year actual recorded severity.

(2) Claim Count Development

The Company generally estimates ultimate claim counts for an accident period based on development of claim counts in prior accident periods. Since 2006, for California automobile BI claims, the Company has experienced that approximately 2% to 5% additional claims will be reported in the year subsequent to an accident year. However, such late reported claims could be more or less than the Company's expectations. Typically, almost every claim is reported within one year following the end of an accident year and at that point the Company has a high degree of certainty as to what the ultimate claim count will be.

There are many other potential factors that can affect the number of claims reported after a period end. These factors include changes in weather patterns, a change in the number of litigated files, the number of automobiles insured, and whether the last day of the period falls on a weekday or a weekend. However, the Company is unable to determine which, if any, of the factors actually impact the number of claims reported and, if so, by what magnitude.

At December 31, 2013, there were 28,029 BI claims reported for the 2013 accident year and the Company estimates that these are expected to ultimately grow by approximately 5%. The Company believes that while actual development in recent years has ranged between approximately 2% to 5%, it is reasonable to expect that the range could be as great as between 0% and 10%. Actual development may be more or less than the expected range. The following table presents the effect on loss development based on different claim count within the broader possible range at December 31, 2013:

California Bodily Injury Claim Count Reserve Sensitivity Analysis

<u>2013 Accident Year</u>	Claims Reported	Amount Recorded at 12/31/13 at 5% Claim Count Development	Total Expected Amount If Claim Count Development is 0%	Total Expected Amount If Claim Count Development is 10%
Claim count	28,029	29,369	28,029	30,832
Approximate average cost per claim	Not meaningful	\$ 10,418	\$ 10,418	\$ 10,418
Total dollars	Not meaningful	\$ 305,966,000	\$ 292,006,000	\$ 321,208,000
Total Loss Development—Favorable (Unfavorable)		\$	13,960,000	\$ (15,242,000)

(3) Unexpected Losses From Older Accident Periods

Unexpected losses are generally not provided for in the current reserve because they are not known or expected and tend to be unquantifiable. Once known, the Company establishes a provision for the losses, but it is not possible to provide any meaningful sensitivity analysis as to the potential size of any unexpected losses. These losses can be caused by many factors, including unexpected legal interpretations of coverage, ineffective claims handling, regulation extending claims reporting periods, assumption of unexpected or unknown risks, adverse court decisions as well as many unknown factors.

Unexpected losses are fairly infrequent but can have a large impact on the Company's losses. To mitigate this risk, the Company has established claims handling and review procedures. However, it is still possible that these procedures will not prove entirely effective, and the Company may have material unexpected losses in future periods. It is also possible that the Company has not identified and established a sufficient reserve for all unexpected large losses occurring in the older accident years, even

though a comprehensive claims file review was undertaken. The Company may experience additional development on these reserves.

Discussion of losses and loss reserves and prior period loss development at December 31, 2013

At December 31, 2013 and 2012, the Company recorded its point estimate of approximately \$1,039 million and \$1,036 million, respectively, in losses and loss adjustment expense liabilities, which include \$409.2 million and \$408.9 million, respectively, of IBNR loss reserves. 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 December 31, 2013 and estimated future payments for reopened claims. Management believes that the liability for losses and loss adjustment expenses 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.

During 2013, the Company recorded catastrophe losses of approximately \$17 million which were primarily due to tornadoes in Oklahoma and severe storms in the Midwest and the Southeast regions during the second quarter.

The Company evaluates its 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 2013, the Company reported unfavorable development of approximately \$3 million on the 2012 and prior accident years' losses and loss adjustment expense reserves, which at December 31, 2012 totaled approximately \$1,036 million. The unfavorable development in 2013 is largely from Florida claims that were re-opened from prior years due to a state supreme court ruling that was adverse to the insurance industry.

Investments

The Company's fixed maturity and equity investments 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 fund 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

The financial instruments recorded in the consolidated balance sheets include investments, receivables, a total return swap, interest rate swaps, accounts payable, equity contracts, 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 disclosed in Note 1 of 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. 99.5% of the fair value of financial instruments held at December 31, 2013 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, for example, the type of financial instrument, whether 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 are otherwise not actively quoted. For a further discussion, see Note 3 of Notes to Consolidated Financial Statements.

Income Taxes

At December 31, 2013, the Company's deferred income taxes were in a net asset position materially due to deferred tax assets resulting from unearned premiums, AMT and other tax credit carryforwards, loss reserve discounting, and expense accruals. These deferred tax assets were substantially offset by deferred tax liabilities generated by deferred policy 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 which 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 and tax-planning strategies available to generate future taxable capital gains, each of which would contribute to the realization of deferred tax benefits. The Company expects to hold certain quantities of debt securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a significant portion of the unrealized loss positions at year-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. The Company also has unrealized gains in its investment portfolio that could be realized through asset dispositions, at management's discretion. Further, the Company has the capability to generate additional realized capital gains by entering into a sale-leaseback transaction using one or more of its appreciated real estate holdings.

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, non-deductible expenses, and periodically, non-routine tax items such as adjustments to unrecognized tax benefits related to tax uncertainties. The effective tax rate was 15.1% for 2013, compared to 13.6% for 2012. The increase in the effective tax rate is mainly due to an increase in taxable income relative to tax exempt investment income and an increase in the provision for the Company's state income tax uncertainties. The Company's effective tax rate for the year ended December 31, 2013 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 also "Regulatory and Legal Matters" and Note 16 of Notes to Consolidated Financial Statements.

For a discussion of recently issued accounting standards, see Note 1 of Notes to Consolidated Financial Statements.

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 on a monthly 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 business become unprofitable, a premium deficiency reserve may be required.

RESULTS OF OPERATIONS

Year Ended December 31, 2013 Compared to Year Ended December 31, 2012

Revenues

Net premiums written and net premiums earned in 2013 increased 2.9% and 4.8%, respectively, from 2012. The increase in net premiums written was primarily due to higher average premiums per policy which primarily resulted from the October 2012 4% rate increase on California private passenger automobile policies as well as rate increases taken in non-California states. In addition, the Company implemented a 6.9% rate increase in July 2013 on private passenger automobile policies written in CAIC, which represented approximately 22% of total California private passenger automobile net premiums written as of December 31, 2013.

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. Net premiums earned, the most directly comparable GAAP measure, represents the portion of net premiums written that is recognized as revenue in the financial statements for the period presented and earned on a pro-rata basis over the term of the policies. The following is a reconciliation of total net premiums written to net premiums earned:

	2013	2012
	(Amounts in thousands)	
Net premiums written	\$ 2,728,999	\$ 2,651,731
Change in net unearned premium	(30,812)	(76,811)
Net premiums earned	<u>\$ 2,698,187</u>	<u>\$ 2,574,920</u>

Expenses

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

	2013	2012
Loss ratio	72.7%	76.2%
Expense ratio	26.9%	26.6%
Combined ratio	<u>99.6%</u>	<u>102.8%</u>

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 \$3 million and \$42 million on prior accident years' losses and loss adjustment expense reserves for the years ended December 31, 2013 and 2012, respectively. The 2013 loss ratio was also negatively impacted by a total of \$17 million of catastrophe losses mostly due to tornadoes in Oklahoma and severe storms in the Midwest and Southeast regions during 2013. The unfavorable development in 2012 was largely the result of re-estimates of California BI losses which experienced both higher average severities and more late reported claims than originally estimated at December 31, 2012. The 2012 loss ratio was also negatively impacted by a total of \$39 million of catastrophe losses mostly due to Hurricane Sandy and wind and hail storms in the Midwest region during 2012. Excluding the effect of estimated prior periods' loss development and catastrophe losses, the loss ratio was 72.0% and 73.0% for the years ended December 31, 2013 and 2012, respectively.

Expense ratio is calculated by dividing the sum of policy acquisition costs plus other operating expenses by net premiums earned and did not materially change in 2013 compared to 2012. The 2013 expense ratio was affected by the consolidation of claims and underwriting operations located outside of California into hub locations, which resulted in approximately \$10 million of pre-tax office closure costs and severance related expense during the first quarter of 2013. The charges added 0.1 point to the expense ratio and 0.3 point to the loss adjustment expense portion of the loss ratio. The Company expects future savings of approximately \$12 million per year as a result of the workforce reduction and operational consolidation.

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 \$20.0 million and \$18.4 million for the years ended December 31, 2013 and 2012, respectively. The increase in income tax expense was due to the recognition of additional state income tax expense.

Investments

The following table presents the investment results of the Company:

	2013	2012
	(Amounts in thousands)	
Average invested assets at cost ⁽¹⁾	\$ 3,028,198	\$ 3,011,143
Net investment income ⁽²⁾		
Before income taxes	\$ 124,538	\$ 131,896
After income taxes	\$ 109,506	\$ 115,359
Average annual yield on investments ⁽²⁾		
Before income taxes	4.1%	4.4%
After income taxes	3.6%	3.8%
Net realized investment (losses) gains	\$ (11,422)	\$ 66,380

- (1) Fixed maturities and short-term bonds at amortized cost; and equities and other short-term investments at cost. Average invested assets at cost is based on the monthly amortized cost of the invested assets for each respective period.
- (2) Net investment income and average annual yield decreased primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during a low interest rate environment.

Included in net income are net realized investment losses of \$11.4 million and gains of \$66.4 million in 2013 and 2012, respectively. Net realized investment (losses) gains include losses of \$44.0 million and gains of \$45.5 million in 2013 and 2012, respectively, due to changes in the fair value of total investments pursuant to application of the fair value accounting option. The net losses during 2013 arise from a \$100.7 million market value decrease in the Company's fixed maturity securities offset by a \$56.8 million market value increase in its equity securities. The Company's municipal bond holdings represent the majority of the fixed maturity portfolio and were negatively affected by the overall municipal market decline for 2013. The primary cause of the increase in the value of the Company's equity securities was the overall improvement in the equity markets for 2013. The net gains during 2012 arise from \$36.3 million and \$9.2 million market value increases in the Company's fixed maturity and equity securities, respectively. The primary cause of the increase in the value of the Company's fixed maturity and equity securities was the overall improvement in the municipal bond market and the equity market in 2012.

Net Income

Net income was \$112.1 million or \$2.04 per share (basic and diluted), and \$116.9 million or \$2.13 per share (basic and diluted) in 2013 and 2012, respectively. Diluted per share results were based on a weighted average of 55.0 million and 54.9 million shares in 2013 and 2012, respectively. Included in net income per share were net realized investment losses, net of income taxes, of \$0.14 and gains, net of income taxes, of \$0.79 per share (basic and diluted) in 2013 and 2012, respectively.

Year Ended December 31, 2012 Compared to Year Ended December 31, 2011

Revenues

Net premiums earned and net premiums written in 2012 increased 0.3% and 3.0%, respectively, from 2011. Net premiums written by the Company's California operations and non-California operations increased by \$73.3 million and \$3.1 million, respectively, from 2011. The increase in net premiums written was primarily due to an increase in the number of policies-in-force and slightly higher average premiums per policy. The increase in average premiums per policy partially reflected a modest shift for the California personal automobile line from six-month policies to twelve-month policies. Premiums on twelve-month policies are typically twice that of six-month policies. For 2012, fewer than 5% of California personal automobile policies were written on a twelve-month basis and more than 95% were written on a six-month basis, whereas in 2011, fewer than 1% of the California personal automobile policies were written on a twelve-month basis and over 99% were written on a six-month basis. In addition, the Company increased private passenger automobile insurance rates in twelve non-California states and grew its homeowners business in several non-California states during 2012.

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

	2012	2011
	(Amounts in thousands)	
Net premiums written	\$ 2,651,731	\$ 2,575,383
Change in net unearned premium	(76,811)	(9,326)
Net premiums earned	<u>\$ 2,574,920</u>	<u>\$ 2,566,057</u>

Expenses

The following table presents the Company's consolidated loss, expense, and combined ratios determined in accordance with GAAP:

	2012	2011
Loss ratio	76.2%	71.3%
Expense ratio	26.6%	27.2%
Combined ratio	<u>102.8%</u>	<u>98.5%</u>

The Company's loss ratio was affected by unfavorable development of approximately \$42 million and \$18 million on prior accident years' losses and loss adjustment expense reserves for the years ended December 31, 2012 and 2011, respectively. The unfavorable development in 2012 was largely the result of re-estimates of California BI losses which experienced both higher average severities and more late reported claims than originally estimated at December 31, 2011. The 2012 loss ratio was also negatively impacted by a total of \$39 million of catastrophe losses mostly due to Hurricane Sandy and wind and hail storms in the Midwest region during 2012. In addition, the 2012 loss ratio was negatively impacted by rising loss frequency and increasing severity on the California private passenger automobile line of business. The 2011 loss ratio was negatively impacted by a total of \$18 million of catastrophe losses due to California winter storms, Hurricane Irene, and Georgia tornadoes during 2011.

The improvement in the expense ratio in 2012 was mainly due to ongoing cost reduction efforts and lower profitability related expenses.

Income tax expenses were \$18.4 million and \$53.9 million for the years ended December 31, 2012 and 2011, respectively. The decrease in income tax expense resulted from decreased taxable income in 2012.

Investments

The following table presents the investment results of the Company:

	2012	2011
	(Amounts in thousands)	
Average invested assets at cost ⁽¹⁾	\$ 3,011,143	\$ 3,004,588
Net investment income ⁽²⁾		
Before income taxes	\$ 131,896	\$ 140,947
After income taxes	\$ 115,359	\$ 124,708
Average annual yield on investments ⁽²⁾		
Before income taxes	4.4%	4.7%
After income taxes	3.8%	4.2%
Net realized investment gains	\$ 66,380	\$ 58,397

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

(2) Net investment income and average annual yield decreased primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during a low interest rate environment.

Included in net income were net realized investment gains of \$66.4 million and \$58.4 million in 2012 and 2011, respectively. Net realized investment gains included gains of \$45.5 million and \$31.3 million in 2012 and 2011, respectively, due to changes in the fair value of total investments pursuant to application of the fair value accounting option. The net gains during 2012 arose

from \$36.3 million and \$9.2 million market value increases in the Company's fixed maturity and equity securities, respectively. The Company's municipal bond holdings represented the majority of the fixed maturity portfolio, which was positively affected by the overall municipal market improvement for 2012. The primary cause of the increase in the value of the Company's equity securities was the overall improvement in the equity markets for 2012. The net gains during 2011 arose from a \$62.1 million market value increase in the Company's fixed maturity securities offset by a \$30.9 million market value decline in its equity securities.

Net Income

Net income was \$116.9 million or \$2.13 per share (basic and diluted) and \$191.2 million or \$3.49 per share (basic and diluted) in 2012 and 2011, respectively. Diluted per share results were based on a weighted average of 54.9 million and 54.8 million shares in 2012 and 2011, respectively. Included in net income per share were net realized investment gains, net of income taxes, of \$0.79 and \$0.69 per share (basic and diluted) in 2012 and 2011, respectively.

LIQUIDITY AND CAPITAL RESOURCES

A. General

The Company is largely dependent upon dividends received from its insurance subsidiaries to pay debt service costs and to make distributions to its shareholders. Under current insurance law, the Insurance Companies are entitled to pay ordinary dividends of approximately \$260 million in 2014 to Mercury General. The Insurance Companies paid Mercury General ordinary dividends of approximately \$120 million during 2013. As of December 31, 2013, Mercury General had approximately \$87 million in investments and cash that could be utilized to satisfy its direct holding company obligations.

The principal sources of funds for the Insurance Companies are premiums, sales and maturity of invested assets, and dividend and interest income from invested assets. The principal uses of funds for the Insurance Companies are the payment of claims and related expenses, operating expenses, dividends to Mercury General, payment of debt, and the purchase of investments.

B. Cash Flows

The Company has generated positive cash flow from operations for more than twenty consecutive years and therefore, does not attempt to match the duration and timing of asset maturities with those of liabilities. Rather, the Company 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 \$582.3 million at December 31, 2013 as well as \$150 million of credit available on a \$200 million revolving credit facility, the Company believes its cash flow 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 in 2013 was \$209.8 million, an increase of \$61.7 million compared to 2012. The increase was primarily due to increased premiums collected and reduced operating expenses, offset by an increase in paid losses and loss adjustment expenses. The Company utilized the cash provided by operating activities primarily for the payment of dividends to its shareholders. Funds derived from the sale, redemption, or maturity of fixed maturity investments of \$571.7 million were primarily reinvested by the Company in high grade fixed maturity securities.

The following table presents the estimated fair value of fixed maturity securities at December 31, 2013 by contractual maturity in the next five years.

	Fixed Maturity Securities	
	(Amounts in thousands)	
Due in one year or less	\$	59,117
Due after one year through two years		55,773
Due after two years through three years		110,949
Due after three years through four years		96,315
Due after four years through five years		73,552
	\$	395,706

See “D. Debt” for cash flow related to outstanding debts.

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 maintains 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 December 31, 2013:

	Cost ⁽¹⁾	Fair Value
	(Amounts in thousands)	
Fixed maturity securities:		
U.S. government bonds and agencies	\$ 15,994	\$ 16,096
Municipal securities	2,201,047	2,235,323
Mortgage-backed securities	37,848	40,247
Corporate securities	264,172	264,685
Collateralized debt obligations	3,981	4,302
	<u>2,523,042</u>	<u>2,560,653</u>
Equity securities:		
Common stock:		
Public utilities	81,128	85,287
Banks, trusts and insurance companies	1,610	2,927
Energy and other	101,455	151,554
Non-redeemable preferred stock	29,740	29,567
Partnership interest in a private credit fund	10,000	12,548
	<u>223,933</u>	<u>281,883</u>
Short-term investments	<u>315,886</u>	<u>315,776</u>
Total investments	<u>\$ 3,062,861</u>	<u>\$ 3,158,312</u>

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

At December 31, 2013, 70.6% of the Company’s total investment portfolio at fair value and 87.1% of its total fixed maturity investments at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of non-redeemable preferred stocks, dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and a partnership interest in a private credit fund. At December 31, 2013, 83.3% 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 investment in subprime lenders.

During 2013, the Company recognized \$11.4 million in net realized investment losses, which primarily included losses of \$95.2 million and gains of \$80.9 million related to fixed maturity and equity securities, respectively. Included in the gains and losses were \$100.7 million in losses and \$56.8 million in gains due to changes in the fair value of the Company’s fixed maturity and equity security portfolio, respectively, as a result of applying the fair value accounting option.

During 2012, the Company recognized \$66.4 million in net realized investment gains, which primarily included gains of \$47.7 million and \$16.7 million related to fixed maturity and equity securities, respectively. Included in the gains were \$36.3

million and \$9.2 million in gains due to changes in the fair value of the Company's fixed maturity and equity security portfolio, respectively, as a result of applying the fair value accounting option.

Fixed Maturity Securities and Short-Term Investments

Fixed maturity securities include debt securities, 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 investments 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 nominal average maturities of the overall bond portfolio were 13.3 years and 12.2 years (12.1 years and 11.0 years including all short-term instruments) at December 31, 2013 and 2012, respectively. The portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity investments purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The call-adjusted average maturities of the overall bond portfolio were 5.2 years and 3.7 years (4.7 years and 3.3 years including all short-term instruments) at December 31, 2013 and 2012, respectively, related to holdings which are heavily weighted with high coupon issues that are expected to be called prior to maturity. The modified durations of the overall bond portfolio reflecting anticipated early calls were 3.9 years and 3.1 years, (3.6 years and 2.8 years including all short-term instruments), including collateralized mortgage obligations with a modified duration of 2.3 years and 3.2 years at December 31, 2013 and 2012, respectively, and short-term bonds that carry no duration. 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.

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of AA-, at fair value, consistent with the average rating at December 31, 2012. To calculate the weighted-average credit quality ratings as disclosed throughout this Annual Report on Form 10-K, individual securities were weighted based on fair value and a credit quality numeric score that was assigned to each rating grade. Tax-exempt bond holdings are broadly diversified geographically. Taxable holdings consist principally of investment grade issues. At December 31, 2013, fixed maturity holdings rated below investment grade and non-rated bonds totaled \$35.0 million and \$13.1 million, respectively, at fair value, and represented 1.4% and 0.5%, respectively, of total fixed maturity securities. At December 31, 2012, fixed maturity holdings rated below investment grade and non-rated bonds totaled \$41.4 million and \$47.4 million, respectively, at fair value, and represented 1.7% and 2.0%, respectively, of total fixed maturity securities.

The following table presents the credit quality ratings of the Company's fixed maturity portfolio by security type at December 31, 2013 at fair value. The Company's estimated credit quality ratings are based on the average of ratings assigned by nationally recognized securities rating organizations. Credit ratings for the Company's fixed maturity portfolio were stable as compared to the prior year, with 83.1% of fixed maturity securities at fair value experiencing no change in their overall rating. 9.3% of fixed maturity securities at fair value experienced downgrades, partially offset by 7.6% in credit upgrades. A majority of the downgrades were slight and still within the investment grade portfolio, except for \$7.4 million at fair value that were downgraded to below investment grade during 2013.

December 31, 2013						
	AAA	AA ⁽¹⁾	A ⁽¹⁾	BBB ⁽¹⁾	Non-Rated/ Other	Total
	(Amounts in thousands)					
U.S. government bonds and agencies:						
Treasuries	\$ 12,747	\$ 0	\$ 0	\$ 0	\$ 0	\$ 12,747
Government Agency	3,349	0	0	0	0	3,349
Total	16,096	0	0	0	0	16,096
	100.0%					100.0%
Municipal securities:						
Insured	6,667	334,350	624,301	20,513	15,175	1,001,006
Uninsured	232,494	337,398	487,889	170,535	6,001	1,234,317
Total	239,161	671,748	1,112,190	191,048	21,176	2,235,323
	10.7%	30.1%	49.8%	8.5%	0.9%	100.0%
Mortgage-backed securities:						
Commercial	0	0	11,519	10,339	0	21,858
Agencies	6,942	0	0	0	0	6,942
Non-agencies:						
Prime	28	462	679	1,615	1,692	4,476
Alt-A	0	19	1,451	0	5,501	6,971
Total	6,970	481	13,649	11,954	7,193	40,247
	17.3%	1.2%	33.9%	29.7%	17.9%	100.0%
Corporate securities:						
Communications	0	0	6,186	4,202	0	10,388
Consumer—cyclical	0	0	6,797	5,555	0	12,352
Consumer—non-cyclical	0	0	0	16,781	0	16,781
Energy	0	0	0	70,881	6,704	77,585
Financial	0	15,876	35,308	54,014	7,835	113,033
Industrial	0	0	1,166	5,707	1,758	8,631
Technology	0	0	0	9,404	3,454	12,858
Basic materials	0	0	0	8,614	0	8,614
Utilities	0	0	2,069	2,374	0	4,443
Total	0	15,876	51,526	177,532	19,751	264,685
		6.0%	19.5%	67.1%	7.4%	100.0%
Collateralized debt obligations:						
Corporate	4,302	0	0	0	0	4,302
Total	4,302	0	0	0	0	4,302
	100.0%					100.0%
Total	\$ 266,529	\$ 688,105	\$ 1,177,365	\$ 380,534	\$ 48,120	\$ 2,560,653
	10.4%	26.9%	46.0%	14.8%	1.9%	100.0%

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

The Company had \$23.0 million, 0.9% of its fixed maturity portfolio, at fair value, in U.S. government bonds and agencies and mortgage-backed securities (Agencies). In August 2011, Standard and Poor's downgraded the U.S. government's long-term sovereign credit rating from AAA to AA+. This downgrade triggered significant volatility in prices for a variety of investments. While Moody's and Fitch affirmed their AAA ratings, they placed a negative outlook in November 2011 and warned of a potential downgrade if no long-term deficit agreement was reached over the next two years. In 2013, while Moody's and S&P affirmed AAA and AA+ ratings, respectively, with a stable outlook, Fitch warned of a potential downgrade from AAA if the debt limit is not raised in time. Fitch has indicated that it will determine if a downgrade is necessary at the end of the first quarter of 2014. These rating agencies' concerns indicate declining confidence that timely fiscal measures will be forthcoming to place U.S. public

finances on a sustainable path and secure the AAA ratings. Standard and Poor's affirmed the U.S. Treasury's short-term credit rating of AAA indicating that the short-term capacity of the U.S. to meet its financial commitment on its outstanding obligations is strong. 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.

(1) Municipal Securities

The Company had \$2.2 billion at fair value and amortized cost in municipal bonds at December 31, 2013, of which \$1.0 billion were insured by bond insurers. For insured municipal bonds that have underlying ratings, the average underlying rating was A+ at December 31, 2013.

At December 31, 2013, the bond insurers providing credit enhancement were Assured Guaranty Corporation and National Public Finance Guarantee Corporation, which covered approximately 25% of the insured municipal securities. The average rating of the Company's insured municipal bonds by these bond insurers was A, with an underlying rating of A-. Most of the insured bonds' ratings were investment grade and reflected the credit of underlying issuer. 8.6% of the remaining insured bonds are non-rated or below investment grade, and the Company does not believe that these insurers provide credit enhancement to the municipal bonds that they insure.

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 fair value of municipal bonds.

(2) Mortgage-Backed Securities

The mortgage-backed securities portfolio is categorized as loans to "prime" borrowers except for \$7.0 million and \$8.2 million (\$6.3 million and \$7.3 million at amortized cost) of Alt-A mortgages at December 31, 2013 and 2012, respectively. 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 \$21.9 million and \$4.3 million (\$21.8 million and \$4.2 million at amortized cost) in commercial mortgage-backed securities at December 31, 2013 and 2012, respectively.

The weighted-average rating of the Company's Alt-A mortgage-backed securities was B+ and the weighted-average rating of the entire mortgage backed securities portfolio was BBB+ as of December 31, 2013.

(3) Corporate Securities

Included in fixed maturity securities are \$264.7 million and \$155.6 million of corporate securities, which had durations of 3.4 and 1.8 years, at December 31, 2013 and 2012, respectively. The weighted-average rating was BBB as of December 31, 2013 and 2012.

(4) Collateralized Debt Obligations

Included in fixed maturities securities are collateralized debt obligations of \$4.3 million and \$42.8 million, which represent 0.1% and 1.3% of the total investment portfolio and had durations of 0.01 years and 0.47 years, at December 31, 2013 and 2012, respectively.

Equity Securities

Equity holdings consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and a partnership interest in a private credit fund. The net gains in 2013 due to changes in fair value of the Company's equity portfolio were \$56.8 million. The primary cause of the increase in the value of the Company's equity securities was the overall improvement in the equity markets.

The Company's common stock allocation is intended to enhance the return of and provide diversification for the total portfolio. At December 31, 2013, 8.9% of the total investment portfolio at fair value was held in equity securities, compared to 15.0% at December 31, 2012. During the second half of 2013, the Company sold a significant portion of its equity portfolio to

improve the asset risk profile in its insurance subsidiaries and to lock in and realize gains that resulted from the large stock market appreciation that occurred during 2013. Those gains can be utilized to offset capital losses for tax purposes within the next three years.

The following table presents the equity security portfolio by industry sector for 2013 and 2012:

	December 31,			
	2013		2012	
	Cost	Fair Value	Cost	Fair Value
	(Amounts in thousands)			
Equity securities:				
Basic materials	\$ 5,401	\$ 7,759	\$ 37,407	\$ 32,862
Communications	3,899	4,538	8,970	10,428
Consumer—cyclical	8,095	8,241	8,337	7,658
Consumer—non-cyclical	1,830	2,836	9,498	10,162
Energy	75,093	121,662	242,961	246,209
Financial	25,242	25,627	27,553	30,075
Funds	10,000	12,548	10,264	11,579
Industrial	5,571	5,260	32,697	29,188
Technology	2,503	2,715	10,567	8,635
Utilities	86,299	90,697	87,705	90,292
	<u>\$ 223,933</u>	<u>\$ 281,883</u>	<u>\$ 475,959</u>	<u>\$ 477,088</u>

D. Debt

Notes payable consists of the following:

	Lender	Interest Rate	Expiration	December 31,	
				2013	2012
				(Amounts in thousands)	
Secured credit facility	Bank of America	LIBOR plus 40 basis points	July 31, 2016	\$ 120,000	\$ 120,000
Secured loan	Union Bank	LIBOR plus 40 basis points	January 2, 2015	20,000	20,000
Unsecured credit facility	Bank of America and Union Bank	(1)	June 30, 2018	50,000	0
Total				<u>\$ 190,000</u>	<u>\$ 140,000</u>

- (1) On July 2, 2013, the Company entered into an unsecured \$200 million five-year revolving credit facility. The interest rate on borrowings under the credit facility is based on the Company's debt to total capital ratio and ranges from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is above 25%. Commitment fees for 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 above 25%. In 2013, the interest rate was LIBOR plus 112.5 basis points on the \$50 million of borrowings and 12.5 basis points on the undrawn portions of the credit facility.

The bank loan and credit facilities contain financial covenants pertaining to minimum statutory surplus, debt to capital ratio, and RBC ratio. The Company was in compliance with all of its loan covenants at December 31, 2013.

For a further discussion, see Notes 6 and 7 of Notes to Consolidated Financial Statements.

E. Capital Expenditures

In 2013, the Company made capital expenditures, including capitalized software, of approximately \$19 million primarily related to Information Technology.

F. Regulatory Capital Requirement

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The RBC formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2013, 2012, and 2011 each of the Insurance Companies exceeded the minimum required RBC levels, as determined by the NAIC and adopted by the state insurance regulators. None of the Insurance Companies' RBC ratio was less than 800% of the authorized control level RBC as of December 31, 2013, 2012, and 2011, respectively. Generally, an RBC ratio of 200% or less would require some form of regulatory or company action.

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 \$1.5 billion at December 31, 2013, and net premiums written of \$2.7 billion, the ratio of premiums written to surplus was 1.8 to 1.

Beginning in 2015, insurance companies will be required to file an ORSA with the insurance regulators in their state of domicile. The ORSA is required to cover, among many items, a company's risk management policies, the material risks to which the company is exposed, how the company measures, monitors, manages and mitigates material risks, and how much economic and regulatory capital is needed to continue to operate in a strong and healthy manner. The ORSA will be used by the state insurance regulator to evaluate the risk exposure and quality of the risk management processes within the insurance companies to assist in conducting risk-focused financial examinations and for determining the overall financial condition of the insurance company.

OFF-BALANCE SHEET ARRANGEMENTS

As of December 31, 2013, the Company had no off-balance sheet arrangements as defined under Regulation S-K 303(a) (4) and the instructions thereto.

CONTRACTUAL OBLIGATIONS

The Company's significant contractual obligations at December 31, 2013 are summarized as follows:

Contractual Obligations	Total	2014	2015	2016	2017	2018	Thereafter
	(Amounts in thousands)						
Debt (including interest) ⁽¹⁾	\$ 216,806	\$ 1,905	\$ 21,787	\$ 121,491	\$ 1,082	\$ 70,541	\$ 0
Lease obligations ⁽²⁾	44,633	13,282	11,214	9,510	7,345	3,112	170
Losses and loss adjustment expenses ⁽³⁾	1,038,984	587,906	254,798	124,583	47,740	23,957	0
Total Contractual Obligations	<u>\$ 1,300,423</u>	<u>\$ 603,093</u>	<u>\$ 287,799</u>	<u>\$ 255,584</u>	<u>\$ 56,167</u>	<u>\$ 97,610</u>	<u>\$ 170</u>

- (1) The Company's debt contains various terms, conditions and covenants which, if violated by the Company, would result in a default and could result in the acceleration of the Company's payment obligations. Amounts differ from the balance presented on the consolidated balance sheets as of December 31, 2013 because the debt amounts above include interest, calculated at the most recent LIBOR rate and bank margin in effect, and an additional draw of \$20 million made subsequent to December 31, 2013.
- (2) The Company is obligated under various non-cancellable lease agreements providing for office space, automobiles, and office equipment that expire at various dates through the year 2019.
- (3) Reserve for losses and loss adjustment expenses is an estimate of amounts necessary to settle all outstanding claims, including IBNR as of December 31, 2013. The Company has estimated the timing of these payments based on its historical experience and expectation of future payment patterns. However, the timing of these payments may vary significantly from the amounts shown above. The ultimate cost of losses may vary materially from recorded amounts which are the Company's best estimates.
- (4) The table excludes liabilities of \$8.4 million related to uncertainty in tax settlements as the Company is unable to reasonably estimate the timing and amount of related future payments.

Item 7A. 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 is due to 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 December 31, 2013, the estimated weighted-average credit quality rating of the fixed maturities portfolio was AA-, at fair value, consistent with the average rating at December 31, 2012. Historically, the ten-year default rate for municipal bonds rated AA by Moody's has been less than 1%. The Company's municipal bond holdings, which represent 87.3% of its fixed maturity portfolio at December 31, 2013, at fair value, are broadly diversified geographically. 99.7% of municipal bond holdings are tax-exempt. The following table presents municipal bond holdings by state in descending order of holdings at fair value at December 31, 2013:

<u>States</u>	<u>Fair Value</u> <u>(Amounts in thousands)</u>	<u>Average Rating</u>
California	\$ 360,209	A+
Texas	355,598	AA-
Florida	204,916	A+
Indiana	131,846	A+
Illinois	131,264	A+
Other states	1,051,490	A+
Total	<u>\$ 2,235,323</u>	

The portfolio is broadly diversified among the states and the largest holdings are in populous states such as California and Texas. 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 12.9% of the Company's fixed maturity portfolio. 6.9% 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 December 31, 2013. 7.0% of the Company's taxable fixed maturity securities, representing 0.9% of the total fixed maturity 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 December 31, 2013, the Company's primary objective for common equity investments was current income. The fair value of the equity investments consisted of \$239.8 million in common stocks, \$29.6 million in non-redeemable preferred stocks, and \$12.5 million in a partnership interest in a private credit fund. Common stock equity assets are typically valued for future economic prospects as perceived by the market. The Company invests proportionately more in the energy and utility sector relative to the S&P 500 Index.

Common stocks represented 7.6% of total investments at fair value. During the second half of 2013, the Company sold a significant portion of its equity portfolio to improve the asset risk profile in its insurance subsidiaries and to lock in and realize gains that resulted from the large stock market appreciation on that occurred during 2013. Beta is a measure of a security's systematic (non-diversifiable) risk, which is measured as 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 December 31, 2013 and 2012:

	December 31,	
	2013	2012
	(Amounts in thousands, except average Beta)	
Average Beta	0.93	1.06
Hypothetical reduction in the overall value of the stock market of 25%	\$ 55,746	\$ 120,332
Hypothetical reduction in the overall value of the stock market of 50%	\$ 111,492	\$ 240,663

After reducing the size of the Company's equity portfolio during 2013, the portfolio at December 31, 2013 had both a lower Beta and a lower total amount invested in common stocks. Therefore, the impact that large market corrections could have on the equity portfolio was lower at December 31, 2013 than at December 31, 2012.

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 the widening credit spreads and credit exposure to collateralized securities.

The value of the fixed maturity portfolio, which represented 81.1% of total investment at fair value, is subject to interest rate risk. As market interest rates decrease, the value of the portfolio increases and vice versa. A common measure of the interest sensitivity of fixed maturity assets 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 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 increased investment in municipal bonds with relatively longer duration in 2013 coupled with a rise in interest rates during the second quarter resulted in an increase in the duration of the Company's portfolio. Consequently, the modified duration of the bond portfolio reflecting anticipated early calls was 3.9 years at December 31, 2013 compared to 3.1 years and 3.7 years at December 31, 2012 and 2011, respectively. Given a hypothetical parallel increase of 100 or 200 basis points in interest rates, the Company estimates that the fair value of its bond portfolio at December 31, 2013 would decrease by \$101.9 million or \$203.8 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 8. Financial Statements and Supplementary Data

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
Mercury General Corporation:

We have audited the accompanying consolidated balance sheets of Mercury General Corporation and subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercury General Corporation and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Mercury General Corporation's internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control—Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 10, 2014 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Los Angeles, California
February 10, 2014

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
Mercury General Corporation:

We have audited Mercury General Corporation's (the Company) internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control—Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Mercury General Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Mercury General Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control—Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Mercury General Corporation and subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013, and our report dated February 10, 2014 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Los Angeles, California
February 10, 2014

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

	December 31,	
	2013	2012
ASSETS		
Investments, at fair value:		
Fixed maturity securities (amortized cost \$2,523,042; \$2,270,903)	\$ 2,560,653	\$ 2,408,354
Equity securities (cost \$223,933; \$475,959)	281,883	477,088
Short-term investments (cost \$315,886; \$294,607)	315,776	294,653
Total investments	<u>3,158,312</u>	<u>3,180,095</u>
Cash	266,508	158,183
Receivables:		
Premiums	366,075	345,387
Accrued investment income	36,120	31,109
Other	23,029	17,756
Total receivables	<u>425,224</u>	<u>394,252</u>
Deferred policy acquisition costs	194,466	185,910
Fixed assets, net	156,716	161,940
Current income taxes	0	7,058
Deferred income taxes	15,220	0
Goodwill	42,796	42,796
Other intangible assets, net	41,603	47,589
Other assets	14,336	11,863
Total assets	<u><u>\$ 4,315,181</u></u>	<u><u>\$ 4,189,686</u></u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Losses and loss adjustment expenses	\$ 1,038,984	\$ 1,036,123
Unearned premiums	953,527	920,429
Notes payable	190,000	140,000
Accounts payable and accrued expenses	127,663	96,220
Current income taxes	11,856	0
Deferred income taxes	0	445
Other liabilities	170,665	153,972
Total liabilities	<u>2,492,695</u>	<u>2,347,189</u>
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value:		
Authorized 70,000 shares; issued and outstanding 54,975; 54,922	81,591	79,380
Additional paid-in capital	411	0
Retained earnings	1,740,484	1,763,117
Total shareholders' equity	<u>1,822,486</u>	<u>1,842,497</u>
Total liabilities and shareholders' equity	<u><u>\$ 4,315,181</u></u>	<u><u>\$ 4,189,686</u></u>

See accompanying notes to consolidated financial statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Year Ended December 31,		
	2013	2012	2011
Revenues:			
Net premiums earned	\$ 2,698,187	\$ 2,574,920	\$ 2,566,057
Net investment income	124,538	131,896	140,947
Net realized investment (losses) gains	(11,422)	66,380	58,397
Other	9,738	10,174	11,884
Total revenues	<u>2,821,041</u>	<u>2,783,370</u>	<u>2,777,285</u>
Expenses:			
Losses and loss adjustment expenses	1,962,690	1,961,448	1,829,205
Policy acquisition costs	505,517	477,788	481,721
Other operating expenses	219,478	207,281	215,711
Interest	1,260	1,543	5,549
Total expenses	<u>2,688,945</u>	<u>2,648,060</u>	<u>2,532,186</u>
Income before income taxes	<u>132,096</u>	<u>135,310</u>	<u>245,099</u>
Income tax expense	19,953	18,399	53,935
Net income	<u>\$ 112,143</u>	<u>\$ 116,911</u>	<u>\$ 191,164</u>
Net income per share:			
Basic	\$ 2.04	\$ 2.13	\$ 3.49
Diluted	\$ 2.04	\$ 2.13	\$ 3.49

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	Year Ended December 31,		
	2013	2012	2011
Net income	\$ 112,143	\$ 116,911	\$ 191,164
Other comprehensive income, before tax:			
Gains on hedging instrument	0	0	1,139
Other comprehensive income, before tax	0	0	1,139
Income tax expense related to gains on hedging instrument	0	0	399
Other comprehensive income, net of tax:	0	0	740
Comprehensive income	<u>\$ 112,143</u>	<u>\$ 116,911</u>	<u>\$ 191,904</u>

See accompanying notes to consolidated financial statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands)

	Year Ended December 31,		
	2013	2012	2011
Common stock, beginning of year	\$ 79,380	\$ 76,634	\$ 74,188
Proceeds of stock options exercised	1,884	2,492	1,951
Share-based compensation expense	125	168	439
Tax benefit on sales of incentive stock options	202	86	56
Common stock, end of year	81,591	79,380	76,634
Additional paid in capital, beginning of year	0	538	78
Share-based compensation expense	849	(538)	460
Exercise of stock options	(438)	0	0
Additional paid in capital, end of year	411	0	538
Accumulated other comprehensive income (loss), beginning of year	0	0	(740)
Other comprehensive income, net of tax	0	0	740
Accumulated other comprehensive income, end of year	0	0	0
Retained earnings, beginning of year	1,763,117	1,780,311	1,721,289
Net income	112,143	116,911	191,164
Dividends paid to shareholders	(134,776)	(134,105)	(132,142)
Retained earnings, end of year	1,740,484	1,763,117	1,780,311
Total shareholders' equity	\$ 1,822,486	\$ 1,842,497	\$ 1,857,483

See accompanying notes to consolidated financial statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended December 31,		
	2013	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 112,143	\$ 116,911	\$ 191,164
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	30,587	36,974	40,657
Net realized investment losses (gains)	11,422	(66,380)	(58,397)
Bond amortization, net	12,529	6,757	4,615
Excess tax benefit from exercise of stock options	(202)	(86)	(56)
Increase in premiums receivable	(20,688)	(56,588)	(7,819)
Changes in current and deferred income taxes	3,451	(83)	45,431
Increase in deferred policy acquisition costs	(8,556)	(14,480)	(851)
Increase (decrease) in unpaid losses and loss adjustment expenses	2,861	50,844	(48,926)
Increase in unearned premiums	33,098	77,002	10,048
Increase (decrease) in accounts payable and accrued expenses	30,367	1,197	(9,985)
Share-based compensation	974	(370)	899
Increase (decrease) in other payables	12,135	2,545	(4,142)
Other, net	(10,317)	(6,181)	(4,113)
Net cash provided by operating activities	209,804	148,062	158,525
CASH FLOWS FROM INVESTING ACTIVITIES			
Fixed maturity securities available for sale in nature:			
Purchases	(831,796)	(590,562)	(379,963)
Sales	228,116	139,860	217,535
Calls or maturities	343,628	528,886	418,616
Equity securities available for sale in nature:			
Purchases	(596,883)	(358,216)	(351,198)
Sales	872,997	277,272	325,562
Calls	0	923	0
Changes in securities payable and receivable	1,702	1,919	(9,137)
Net increase in short-term investments	(20,005)	(58,949)	(93,737)
Purchase of fixed assets	(18,671)	(15,177)	(18,079)
Sale of fixed assets	820	2,044	2,990
Other, net	1,741	2,255	12,026
Net cash (used in) provided by investing activities	(18,351)	(69,745)	124,615
CASH FLOWS FROM FINANCING ACTIVITIES			
Dividends paid to shareholders	(134,776)	(134,105)	(132,142)
Excess tax benefit from exercise of stock options	202	86	56
Payment to retire senior notes	0	0	(125,000)
Payoff bank loan	0	0	(18,000)
Proceeds from stock options exercised	1,446	2,492	1,951
Proceeds from bank loan	50,000	0	20,000
Net cash used in financing activities	(83,128)	(131,527)	(253,135)
Net increase (decrease) in cash	108,325	(53,210)	30,005
Cash:			
Beginning of year	158,183	211,393	181,388
End of year	\$ 266,508	\$ 158,183	\$ 211,393
SUPPLEMENTAL CASH FLOW DISCLOSURE			
Interest paid	\$ 998	\$ 1,690	\$ 6,193
Income taxes paid	\$ 16,503	\$ 18,481	\$ 8,503

See accompanying notes to consolidated financial statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
NOTES STATEMENTS TO CONSOLIDATED FINANCIAL

1. Summary of Significant Accounting Policies

General

Mercury General Corporation (“Mercury General”) and its subsidiaries (referred to herein collectively as the “Company”) are primarily engaged in writing personal automobile insurance through 13 Insurance Companies in 13 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical breakdown, fire, and umbrella insurance. The private passenger automobile lines of insurance exceeded 79% of the Company’s direct premiums written in 2013, 2012, and 2011, of which approximately 81%, 78%, and 77% of the private passenger automobile premiums were written in California during 2013, 2012, and 2011, respectively. Premiums written represents the premiums charged on policies issued during a fiscal period, which is a statutory measure designed to determine production levels.

Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries:

Insurance Companies

Mercury Casualty Company (“MCC”)	Mercury National Insurance Company
Mercury Insurance Company (“MIC”)	American Mercury Insurance Company
California Automobile Insurance Company (“CAIC”)	American Mercury Lloyds Insurance Company ⁽¹⁾
California General Underwriters Insurance Company, Inc.	Mercury County Mutual Insurance Company ⁽²⁾
Mercury Insurance Company of Illinois	Mercury Insurance Company of Florida
Mercury Insurance Company of Georgia	Mercury Indemnity Company of America
Mercury Indemnity Company of Georgia	

Non-Insurance Companies

Mercury Select Management Company, Inc.	AIS Management LLC
Mercury Insurance Services LLC	Auto Insurance Specialists LLC
Animas Funding LLC (“AFL”) ⁽³⁾	PoliSeek AIS Insurance Solutions, Inc.
Concord Insurance Services, Inc. ⁽⁴⁾	Mercury Group, Inc. ⁽⁵⁾
American Mercury MGA, Inc. ⁽⁵⁾	

- (1) American Mercury Lloyds Insurance Company is not owned but is controlled by the Company through its attorney-in-fact, Mercury Select Management Company, Inc.
- (2) Mercury County Mutual Insurance Company is not owned but is controlled by the Company through a management contract.
- (3) Special purpose investment vehicle formed in 2013.
- (4) Inactive company dissolved in 2013.
- (5) Inactive companies dissolved in 2012.

The consolidated 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. All intercompany transactions and balances have been eliminated.

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 revenue 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 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.

Investments

The Company applies the fair value option to all fixed maturities 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 and losses are included in net realized investment (losses) gains. Gains and 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 (losses) gains, while interest and dividend income on the investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income. 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 Financial Accounting Standards Board ("FASB") for accounting for financial instruments. See Note 2 for additional information regarding the fair value option.

Fixed maturity securities include debt securities, 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. Premiums and discounts on fixed maturities are amortized using first call date and are adjusted for anticipated prepayments. Premiums and discounts on mortgage-backed securities are adjusted for anticipated prepayment using the retrospective method, with the exception of some beneficial interests in securitized financial assets, which are accounted for using the prospective method.

Equity securities consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend received deduction, and a partnership interest in a private credit fund.

Short-term investments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

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 on the expiration date as realized gains from investments. 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 of \$0.1 million and \$0.2 million were included in other liabilities at December 31, 2013 and 2012, respectively.

Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, a total return swap, interest rate swaps, accounts payable, equity contracts, and secured and unsecured notes payable. As discussed above, all investments are carried at fair value on the consolidated balance sheets, including \$4.3 million and \$12.5 million of fixed maturities and equity securities, respectively, which are valued based on broker quotes for underlying debt and credit instruments and an estimated benchmark spread for similar assets in active markets. The fair value of the Company's \$120 million and \$20 million secured notes, classified as Level 2 in the fair value hierarchy described in Note 3, is 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. The fair value of the Company's \$50 million unsecured note, classified as Level 2 in the fair value hierarchy described in Note 3, is based on the unadjusted quoted price for similar notes in active markets. See Note 3 for methods and assumptions used in estimating fair values of the total return swap, interest rate swaps, and equity contracts. Due to their short-term maturity, the carrying values of receivables and accounts payable approximate their fair market values. The following table presents estimated fair values of financial instruments at December 31, 2013 and 2012.

	December 31,	
	2013	2012
	(Amounts in thousands)	
Assets		
Investments	\$ 3,158,312	\$ 3,180,095
Total return swap	\$ 1,650	\$ 0
Liabilities		
Interest rate swap agreements	\$ 0	\$ 103
Equity contracts	\$ 140	\$ 175
Secured notes	\$ 140,000	\$ 140,000
Unsecured note	\$ 50,000	\$ 0

Total Return Swap

In 2013, the Company formed and consolidated AFL, a special purpose investment vehicle. The Company is the sole managing member in AFL. On August 9, 2013, AFL entered into a three-year total return swap agreement with Citibank, N.A. (“Citibank”). Under the total return swap agreement, AFL receives the income equivalent on underlying obligations and pays to Citibank interest equal to LIBOR plus 120 basis points on the outstanding notional amount of the underlying obligations, which was approximately \$149 million as of December 31, 2013. The total return swap agreement is secured by approximately \$40 million of U.S. Treasuries as collateral, which is included in short-term investments on the consolidated balance sheets. In the event of a significant erosion in market value, AFL's position in the loan portfolio will be reduced and the Company has the option to add additional capital or terminate the total return swap agreement.

Securities on Deposit

The Company's 13 insurance subsidiaries (referred to herein collectively as the “Insurance Companies”) have securities deposited with the Department of Insurance or similar governmental agency of each state in which it is licensed to operate (“DOI”) as required by statute with fair values of approximately \$17 million and \$16 million at December 31, 2013 and 2012, respectively.

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 \$505.5 million, \$477.8 million, and \$481.7 million during the years ended December 31, 2013, 2012, and 2011, respectively. The Company does not defer advertising expenses but expenses them as incurred. The Company recorded net advertising expenses of approximately \$20 million, \$19 million, and \$21 million during the years ended December 31, 2013, 2012, and 2011, respectively.

Fixed Assets

Fixed assets are stated at historical cost less accumulated depreciation and amortization. The useful life for buildings is 30 to 40 years. Furniture, equipment, and purchased software are depreciated on a combination of straight-line and accelerated methods over 3 to 7 years. The Company has capitalized certain consulting costs, payroll, and payroll-related costs for employees related to computer software developed for internal use, which are amortized on a straight-line method over the estimated useful life of the software, generally not exceeding 5 years. In accordance with applicable accounting standards, capitalization ceases no later than the point at which a computer software project is substantially complete and ready for its intended use. Leasehold improvements are amortized over the shorter of the useful life of the assets or the life of the associated lease.

The Company periodically assesses long-lived assets or asset groups including building and equipment, for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. If the Company identifies an indicator of impairment, the Company assesses recoverability by comparing the carrying amount of the asset to the sum of the undiscounted cash flows expected to result from the use and the eventual disposal of the asset. An impairment loss is recognized when the carrying amount is not recoverable and is measured as the excess of carrying value over fair value. The Company recorded no impairment charges during the three years ended December 31, 2013.

Goodwill and Other Intangible Assets

Goodwill and other intangible assets arise as a result of business acquisitions and consist of the excess of the cost of the acquisitions over the tangible and intangible assets acquired and liabilities assumed and identifiable intangible assets acquired. Identifiable intangible assets consist of the value of customer relationships, trade names, software and technology, and favorable leases, which are all subject to amortization.

The Company annually evaluates goodwill and other intangible assets for impairment. The Company also reviews its goodwill and other intangible assets for impairment whenever events or changes in circumstances indicate that it is more likely than not that the carrying amount of goodwill may exceed its implied fair value. The Company qualitatively determines whether, more likely than not, the fair value exceeds the carrying amount of a reporting unit. There are numerous assumptions and estimates underlying the qualitative assessments including future earnings, long-term strategies, and the Company's annual planning and forecasting process. If these planned initiatives do not accomplish the targeted objectives, the assumptions and estimates underlying the qualitative assessments could be adversely affected and have a material effect upon the Company's financial condition and results of operations. As of December 31, 2013 and 2012, goodwill and other intangible impairment assessments indicated that there was no impairment.

Premium Revenue Recognition

Premium revenue is recognized on a pro-rata basis over the term of the policies in proportion to the amount of insurance protection provided. Premium revenue includes installment and other fees for services which are recognized in the periods the services are rendered. Unearned premiums represent the portion of the premium related to the unexpired policy term. Unearned premiums are predominantly computed on a monthly pro-rata basis and are stated gross of reinsurance deductions, with the reinsurance deduction recorded in other receivables. Net premiums written, a statutory measure designed to determine production levels, were \$2.73 billion, \$2.65 billion, and \$2.58 billion in 2013, 2012, and 2011, respectively.

Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses are determined in amounts estimated to cover incurred losses and loss adjustment expenses and established based upon the Company's assessment of claims pending and the development of prior years' loss liabilities. These amounts include liabilities based upon individual case estimates for reported losses and loss adjustment expenses and estimates of such amounts that are incurred but not reported. Changes in the estimated liability are charged or credited to operations as the losses and loss adjustment expenses are reestimated. The liability is stated net of anticipated salvage and subrogation recoveries. The amount of reinsurance recoverable is included in other receivables.

Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the reserve that is required. Changes in the regulatory and legal environment, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact ultimate claim costs. 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, such as those involving the Company's bodily injury (BI) coverages. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date. Since the provisions for loss reserves are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company analyzes loss reserves quarterly primarily using the incurred loss, claim count development, and average severity methods described below. The Company also uses the paid loss development method to analyze loss adjustment expense reserves as part of its reserve analysis. 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 business or coverage within a line of business. When establishing the 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.

- The *incurred loss development 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 development*

method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of business which have a long operating history.

- 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 reserves. 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 *paid loss development method* analyzes historical payment patterns to estimate the amount of losses yet to be paid. The Company uses this method for losses and loss adjustment expenses.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on reserves established by adjusters and average losses on previous similar catastrophes.

Derivative Financial Instruments

The Company accounts for all derivative instruments, other than those that meet the normal purchases and sales exception, as either an asset or liability, measured at fair value, which is based on information obtained from independent parties. In addition, changes in fair value are recognized in earnings unless specific hedge accounting criteria are met. The Company's derivative instruments include a total return swap and interest rate swaps. See Note 7.

Earnings Per Share

Basic earnings per share excludes dilution and reflects net income divided by the weighted average shares of common stock outstanding during the period presented. Diluted earnings per share is based on the weighted average shares of common stock and potential dilutive common stock outstanding during the period presented. At December 31, 2013 and 2012, potential dilutive common stocks consist of outstanding stock options. Note 15 contains the required disclosures relating to the calculation of basic and diluted earnings per share.

Segment Reporting

Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assessing performance. The Company does not have any operations that require separate disclosure as reportable operating segments for the periods presented.

The annual direct premiums written attributable to the Company's lines of insurance were as follows:

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Private passenger automobile	\$ 2,165,557	\$ 2,140,531	\$ 2,105,602
Homeowners	340,013	318,295	285,188
Commercial automobile	104,689	74,655	75,642
Other lines	127,213	122,239	113,251
Total	<u>\$ 2,737,472</u>	<u>\$ 2,655,720</u>	<u>\$ 2,579,683</u>

Income Taxes

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. 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 December 31, 2013, 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 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.

Reinsurance

Liabilities for unearned premiums and unpaid losses are stated in the accompanying consolidated financial statements before deductions for ceded reinsurance. The ceded amounts are immaterial and are carried in other receivables. Earned premiums are stated net of deductions for ceded reinsurance.

The Insurance Companies, as primary insurers, are required to pay losses to the extent reinsurers are unable to discharge their obligations under the reinsurance agreements.

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, which is the option vesting term of four or five years for options granted prior to 2008 and four years for options granted subsequent to January 1, 2008, for only those shares expected to vest. 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.

Under the Company's 2005 Incentive Award Plan (the "2005 Plan"), the Compensation Committee of the Company's Board of Directors granted performance vesting restricted stock units to the Company's senior management and key employees as follows:

	Grant Year		
	2013	2012	2011
Three-year performance period ending December 31,	2015	2014	2013
Vesting shares, target	84,500	89,000	80,000
Vesting shares, maximum	190,125	200,250	120,000

The restricted stock units 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. 2011 grants vest based on the Company's cumulative underwriting income. 2012 grants vest based on the Company's cumulative underwriting income and net premium written growth. 2013 grants vest based on the Company's cumulative underwriting income, annual underwriting income, and net premiums written growth.

The fair value of each restricted stock unit grant was determined based on the market price on the date of grant. 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 would be recognized and any recognized compensation cost would be reversed. For the 2012 and 2011 grants, the achievement of the performance condition set by the Compensation Committee was no longer considered probable, and previously recognized compensation costs were reversed as of December 31, 2013. See Note 14 for additional disclosures.

Recently Issued Accounting Standards

In July 2013, the FASB issued a new standard that requires entities to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when the uncertain tax position would reduce the net operating loss or other carryforward under the tax law of the applicable jurisdiction and when the entity intends to use the deferred tax asset for that purpose. The new standard will be effective for fiscal years and interim periods within those years that begin after December 15, 2013. The adoption of the new standard will not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued a new standard that requires entities to disclose additional information about items reclassified out of accumulated other comprehensive income in their financial statements. Entities are required to include information about changes in accumulated other comprehensive income balances by component and additional information about significant items reclassified out of accumulated other comprehensive income in their interim reporting periods. The Company adopted the new standard which became effective for the interim period ended March 31, 2013. The adoption of the new standard did not have any impact on the Company's consolidated financial statements.

2. Investments

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

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Fixed maturity securities	\$ (100,703)	\$ 36,317	\$ 62,149
Equity securities	56,822	9,158	(30,879)
Short-term investments	(156)	34	19
Total	<u>\$ (44,037)</u>	<u>\$ 45,509</u>	<u>\$ 31,289</u>

A summary of net realized investment (losses) gains is as follows:

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Net realized (losses) gains from investments and other liabilities:			
Fixed maturity securities	\$ (95,225)	\$ 47,707	\$ 54,112
Equity securities	80,910	16,679	(4,854)
Short-term investments	(1,059)	(686)	139
Total return swap	2,176	0	0
Options	1,776	2,680	9,000
Total	<u>\$ (11,422)</u>	<u>\$ 66,380</u>	<u>\$ 58,397</u>

Gross gains and losses realized on the sales of investments, excluding options, are shown below:

	Year Ended December 31,								
	2013			2012			2011		
	(Amounts in thousands)								
	Gross Realized Gains	Gross Realized Losses	Net	Gross Realized Gains	Gross Realized Losses	Net	Gross Realized Gains	Gross Realized Losses	Net
Fixed maturity securities	\$ 9,320	\$ (3,842)	\$ 5,478	\$ 11,473	\$ (83)	\$ 11,390	\$ 2,675	\$ (10,712)	\$ (8,037)
Equity securities	82,385	(58,297)	24,088	19,538	(12,017)	7,521	41,872	(15,847)	26,025
Short-term investments	0	(903)	(903)	2	(722)	(720)	120	0	120

Contractual Maturity

At December 31, 2013, fixed maturity holdings rated below investment grade and non-rated comprised 1.5% of total investments at fair value. Additionally, the Company owns securities that are credit enhanced by financial guarantors that are subject to uncertainty related to market perception of the guarantors' ability to perform. Determining the estimated fair value of municipal bonds could become more difficult should markets for these securities become illiquid. The estimated fair values at December 31, 2013 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Estimated Fair Value (Amounts in thousands)
Fixed maturity securities:	
Due in one year or less	\$ 59,117
Due after one year through five years	336,590
Due after five years through ten years	564,076
Due after ten years	1,600,870
Total	<u>\$ 2,560,653</u>

Investment Income

A summary of net investment income is shown in the following table:

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Fixed maturity securities	\$ 107,926	\$ 117,557	\$ 130,895
Equity securities	18,249	15,831	10,869
Short-term investments	2,702	2,073	1,747
Total investment income	<u>\$ 128,877</u>	<u>\$ 135,461</u>	<u>\$ 143,511</u>
Less: investment expense	(4,339)	(3,565)	(2,564)
Net investment income	<u>\$ 124,538</u>	<u>\$ 131,896</u>	<u>\$ 140,947</u>

3. 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 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 set 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 on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with inputs used to measure their fair value 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.
- Level 2** 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;
 - 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 99.5% of its portfolio from an independent pricing service. For 0.5% 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 December 31, 2013.

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.

Equity contracts: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on 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 mortgage loans and 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. The Company had holdings of \$21.9 million and \$4.3 million at December 31, 2013 and 2012, 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 swap/Interest rate swap: Valued based on 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.

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.

Collateralized debt obligations/Partnership interest in a private credit fund: Valued based on underlying debt and 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 (losses) gains 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 as of December 31, 2013 and 2012, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

	December 31, 2013			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	\$ 16,096	\$ 0	\$ 0	\$ 16,096
Municipal securities	0	2,235,323	0	2,235,323
Mortgage-backed securities	0	40,247	0	40,247
Corporate securities	0	264,685	0	264,685
Collateralized debt obligations	0	0	4,302	4,302
Equity securities:				
Common stock:				
Public utilities	85,287	0	0	85,287
Banks, trusts and insurance companies	2,927	0	0	2,927
Energy and other	151,554	0	0	151,554
Non-redeemable preferred stock	0	29,567	0	29,567
Partnership interest in a private credit fund	0	0	12,548	12,548
Short-term bonds	39,998	12,890	0	52,888
Money market instruments	262,888	0	0	262,888
Total return swap	0	1,650	0	1,650
Total assets at fair value	<u>\$ 558,750</u>	<u>\$ 2,584,362</u>	<u>\$ 16,850</u>	<u>\$ 3,159,962</u>
Liabilities				
Equity contracts	140	0	0	140
Total liabilities at fair value	<u>\$ 140</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 140</u>

	December 31, 2012			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	\$ 14,204	\$ 0	\$ 0	\$ 14,204
Municipal securities	0	2,165,095	0	2,165,095
Mortgage-backed securities	0	30,703	0	30,703
Corporate securities	0	155,551	0	155,551
Collateralized debt obligations	0	0	42,801	42,801
Equity securities:				
Common stock:				
Public utilities	85,106	0	0	85,106
Banks, trusts and insurance companies	22,166	0	0	22,166
Energy and other	346,809	0	0	346,809
Non-redeemable preferred stock	0	11,701	0	11,701
Partnership interest in a private credit fund	0	0	11,306	11,306
Short-term bonds	0	24,530	0	24,530
Money market instruments	270,123	0	0	270,123
Total assets at fair value	<u>\$ 738,408</u>	<u>\$ 2,387,580</u>	<u>\$ 54,107</u>	<u>\$ 3,180,095</u>
Liabilities				
Equity contracts	\$ 175	\$ 0	\$ 0	\$ 175
Interest rate swap agreements	0	103	0	103
Total liabilities at fair value	<u>\$ 175</u>	<u>\$ 103</u>	<u>\$ 0</u>	<u>\$ 278</u>

The following table presents a summary of changes in fair value of Level 3 financial assets and financial liabilities held at fair value at December 31:

	2013		2012	
	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund
	(Amounts in thousands)			
Beginning Balance	\$ 42,801	\$ 11,306	\$ 47,503	\$ 10,008
Realized gains included in earnings	740	1,242	7,975	1,298
Purchase	0	0	25,000	0
Sales	(30,975)	0	(37,677)	0
Settlements	(8,264)	0	0	0
Ending Balance	<u>\$ 4,302</u>	<u>\$ 12,548</u>	<u>\$ 42,801</u>	<u>\$ 11,306</u>
The amount of total gains (losses) for the period included in earnings attributable to assets still held at December 31	<u>\$ 321</u>	<u>\$ 1,242</u>	<u>\$ (3,017)</u>	<u>\$ 1,298</u>

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy in 2013 or 2012.

At December 31, 2013, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

4. Fixed Assets

Fixed assets consist of the following:

	December 31,	
	2013	2012
	(Amounts in thousands)	
Land	\$ 26,770	\$ 26,770
Buildings and improvements	127,940	126,726
Furniture and equipment	108,819	106,788
Capitalized software	147,140	133,477
Leasehold improvements	8,610	7,593
	419,279	401,354
Less accumulated depreciation and amortization	(262,563)	(239,414)
Fixed assets, net	\$ 156,716	\$ 161,940

Depreciation expense including amortization of leasehold improvements was \$24.6 million, \$30.8 million, and \$34.3 million during 2013, 2012, and 2011, respectively.

5. Deferred Policy Acquisition Costs

Deferred policy acquisition costs are as follows:

	December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Balance, beginning of year	\$ 185,910	\$ 171,430	\$ 170,579
Policy acquisition costs deferred	514,073	492,268	482,572
Amortization	(505,517)	(477,788)	(481,721)
Balance, end of year	\$ 194,466	\$ 185,910	\$ 171,430

6. Notes Payable

Notes payable consists of the following:

				December 31,	
Lender		Interest Rate	Expiration	2013	2012
				(Amounts in thousands)	
Secured credit facility	Bank of America	LIBOR plus 40 basis points	July 31, 2016	\$ 120,000	\$ 120,000
Secured loan	Union Bank	LIBOR plus 40 basis points	January 2, 2015	20,000	20,000
Unsecured credit facility	Bank of America and Union Bank	(1)	June 30, 2018	50,000	0
Total				\$ 190,000	\$ 140,000

- (1) On July 2, 2013, the Company entered into an unsecured \$200 million five-year revolving credit facility. The interest rate on borrowings under the credit facility is based on the Company's debt to total capital ratio and ranges from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is above 25%. Commitment fees for 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 above 25%. In 2013, the interest rate was LIBOR plus 112.5 basis points on the \$50 million of borrowings and 12.5 basis points on the undrawn portions of the credit facility.

The \$120 million credit facility and \$20 million bank loan are secured by municipal bonds held as collateral. These secured notes call for the collateral requirement to be greater than the loan amount. The collateral requirement is calculated as the fair market value of the municipal bonds held as collateral multiplied by the advance rates, which vary based on the credit quality and duration of the assets held and range between 75% and 100% of the fair value of each bond.

The bank loan and credit facilities contain financial covenants pertaining to minimum statutory surplus, debt to capital ratio, and risk-based capital (“RBC”) ratio. The Company was in compliance with all of its loan covenants at December 31, 2013.

The aggregated maturities for notes payable are as follows:

<u>Year</u>	<u>Maturity</u> (Amounts in thousands)
2014	\$ 0
2015	\$ 20,000
2016	\$ 120,000
2017	\$ 0
2018	\$ 50,000

For additional disclosures regarding methods and assumptions used in estimating fair values of interest rate swap agreements associated with the Company’s loans listed above, see Note 7.

7. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities. Interest rate swaps are intended to manage the interest rate risk associated with the Company’s debts with fixed or floating rates.

On August 9, 2013, AFL entered into a three-year total return swap agreement with Citibank. Under the total return swap agreement, AFL receives the income equivalent on underlying obligations and pays to Citibank interest equal to LIBOR plus 120 basis points on the outstanding notional amount of the underlying obligations, which was approximately \$149 million as of December 31, 2013. The total return swap is secured by approximately \$40 million of U.S. Treasuries as collateral, which is included in short-term investments on the consolidated balance sheets.

On February 6, 2009, the Company entered into an interest rate swap of its floating LIBOR rate on a \$120 million credit facility for a fixed rate of 1.93% that matured on January 3, 2012. The purpose of the swap was to offset the variability of cash flows resulting from the variable interest rate. The swap was not designated as a hedge and changes in the fair value were adjusted through the consolidated statements of operations in the period of change.

On March 3, 2008, the Company entered into an interest rate swap of its floating LIBOR rate on a Bank of America \$18 million LIBOR plus 50 basis points loan for a fixed rate of 4.25% that matured on March 1, 2013. The swap was designated as a cash flow hedge and the fair market value of the interest rate swap was reported as a component of other comprehensive income and amortized into earnings over the term of the hedged transaction. On October 4, 2011, the Company refinanced the \$18 million loan that was scheduled to mature on March 1, 2013 with a Union Bank \$20 million LIBOR plus 40 basis points loan that matures on January 2, 2015. The related interest swap was deemed to become ineffective and was no longer designated as a hedge. The related interest rate swap expired on March 1, 2013.

Fair value amounts, and gains and losses on derivative instruments

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

	<u>Asset Derivatives</u>		<u>Liability Derivatives</u>	
	<u>December 31, 2013</u>	<u>December 31, 2012</u>	<u>December 31, 2013</u>	<u>December 31, 2012</u>
	(Amounts in thousands)			
Total return swap - Other assets	\$ 1,650	\$ 0	\$ 0	\$ 0
Equity contracts - Other liabilities	0	0	(140)	(175)
Interest rate swap - Other liabilities	0	0	0	(103)
Total derivatives	\$ 1,650	\$ 0	\$ (140)	\$ (278)

<u>Derivatives Contracts for Cash Flow Hedges</u>	Gain Recognized in Comprehensive Income		
	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Interest rate contracts—Other comprehensive income	\$ 0	\$ 0	\$ 1,139

	Gain Recognized in Income		
	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Total return swap - Net realized investment (losses) gains	\$ 2,177	\$ 0	\$ 0
Equity contracts—Net realized investment (losses) gains	1,776	2,680	9,000
Interest rate contract - Other revenue	103	567	1,232
Total	\$ 4,056	\$ 3,247	\$ 10,232

Most equity contracts 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. For additional disclosures regarding equity contracts, see Note 3.

8. Goodwill and Other Intangible Assets

Goodwill

There were no changes in the carrying amount of goodwill for the year ended December 31, 2013. Goodwill is reviewed for impairment on an annual basis and more frequently if potential impairment indicators exist. No impairment indications were identified during any of the periods presented.

Other Intangible Assets

The following table presents the components of other intangible assets as of December 31, 2013 and 2012.

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Useful Lives
	(Amounts in thousands)			(in years)
As of December 31, 2013:				
Customer relationships	\$ 51,755	\$ (24,494)	\$ 27,261	11
Trade names	15,400	(3,208)	12,192	24
Technology	4,300	(2,150)	2,150	10
Favorable leases	1,725	(1,725)	0	3
Software	550	(550)	0	2
Total intangible assets, net	<u>\$ 73,730</u>	<u>\$ (32,127)</u>	<u>\$ 41,603</u>	
As of December 31, 2012:				
Customer relationships	\$ 51,755	\$ (19,585)	\$ 32,170	11
Trade names	15,400	(2,567)	12,833	24
Technology	4,300	(1,720)	2,580	10
Favorable leases	1,725	(1,719)	6	3
Software	550	(550)	0	2
Total intangible assets, net	<u>\$ 73,730</u>	<u>\$ (26,141)</u>	<u>\$ 47,589</u>	

Intangible assets are amortized on a straight-line basis over their useful lives. Intangible assets amortization expenses were \$6.0 million, \$6.2 million, and \$6.4 million during 2013, 2012, and 2011, respectively. None of the intangible assets are anticipated to have a residual value. The following table presents the estimated future amortization expense related to intangible assets as of December 31, 2013:

<u>Year Ending December 31,</u>	<u>Amortization Expense</u> <u>(Amounts in thousands)</u>
2014	\$ 5,980
2015	5,980
2016	5,980
2017	5,253
2018	5,239
Thereafter	13,171
Total	<u>\$ 41,603</u>

9. Income Taxes

Income tax provision

The Company and its subsidiaries file a consolidated federal income tax return. The provision for income tax expense consists of the following components:

	<u>Year Ended December 31,</u>		
	<u>2013</u>	<u>2012</u>	<u>2011</u>
	<u>(Amounts in thousands)</u>		
Federal			
Current	\$ 30,266	\$ 9,340	\$ 31,390
Deferred	(14,970)	6,238	20,518
	<u>\$ 15,296</u>	<u>\$ 15,578</u>	<u>\$ 51,908</u>
State			
Current	\$ 5,234	\$ 2,079	\$ 2,934
Deferred	(577)	742	(907)
	<u>\$ 4,657</u>	<u>\$ 2,821</u>	<u>\$ 2,027</u>
Total			
Current	\$ 35,500	\$ 11,419	\$ 34,324
Deferred	(15,547)	6,980	19,611
Total	<u>\$ 19,953</u>	<u>\$ 18,399</u>	<u>\$ 53,935</u>

The income tax provision reflected in the consolidated statements of operations is reconciled to the federal income tax on income before income taxes based on a statutory rate of 35% as shown in the table below:

	<u>Year Ended December 31,</u>		
	<u>2013</u>	<u>2012</u>	<u>2011</u>
	<u>(Amounts in thousands)</u>		
Computed tax expense at 35%	\$ 46,234	\$ 47,359	\$ 85,785
Tax-exempt interest income	(26,381)	(27,789)	(31,414)
Dividends received deduction	(2,239)	(1,482)	(1,704)
State tax expense	4,944	1,918	1,299
Other, net	(2,605)	(1,607)	(31)
Income tax expense	<u>\$ 19,953</u>	<u>\$ 18,399</u>	<u>\$ 53,935</u>

Deferred Income Taxes

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 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-planing 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. Significant components of the Company's net deferred tax assets and liabilities are as follows:

	December 31,	
	2013	2012
	(Amounts in thousands)	
Deferred tax assets:		
20% of net unearned premium	\$ 68,586	\$ 66,353
Discounting of loss reserves and salvage and subrogation recoverable for tax purposes	12,810	15,019
Write-down of impaired investments	1,714	1,723
Tax credit carryforward	40,309	37,557
Expense accruals	12,497	10,910
Other deferred tax assets	5,653	4,860
Total gross deferred tax assets	141,569	136,422
Deferred tax liabilities:		
Deferred acquisition costs	(68,063)	(65,069)
Tax liability on net unrealized gain on securities carried at fair value	(33,964)	(48,483)
Tax depreciation in excess of book depreciation	(9,667)	(10,191)
Undistributed earnings of insurance subsidiaries	(4,024)	(4,499)
Tax amortization in excess of book amortization	(1,447)	(914)
Other deferred tax liabilities	(9,184)	(7,711)
Total gross deferred tax liabilities	(126,349)	(136,867)
Net deferred tax assets (liabilities)	\$ 15,220	\$ (445)

Uncertainty in Income Taxes

The Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return only if, "more-likely-than-not" the positions are 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 \$4.9 million increase to the total amount of unrecognized tax benefits related to tax uncertainties during 2013. The increase was the result of tax positions taken regarding federal tax credit carryforwards and 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 in the U.S. federal jurisdiction and various states. Tax years that remain subject to examination by major taxing jurisdictions are 2010 through 2012 for federal taxes and 2003 through 2012 for California state taxes. The Company is currently under examination by the California Franchise Tax Board ("FTB") for tax years 2003 through 2010. The FTB issued Notices of Proposed Assessments to the Company for tax years 2003 through 2006, which were affirmed following an administrative protest process with the FTB examination. The Company is considering its options for resolving the case. No assessments have been received for tax years 2007 through 2010. Management believes that the resolution of these examinations and assessments will not have a material impact on the consolidated financial statements.

A reconciliation of the beginning and ending balances of unrecognized tax benefits is as follows:

	2013	2012
	(Amounts in thousands)	
Balance at January 1	\$ 5,926	\$ 4,567
Additions based on tax positions related to:		
Current year	1,225	330
Prior years	3,633	1,539
Additions (reductions) based on tax positions related to prior years	0	(308)
Additions (reductions) as a result of lapse of the applicable statute of limitations	0	(202)
Balance at December 31	<u>\$ 10,784</u>	<u>\$ 5,926</u>

As presented above, the balances of unrecognized tax benefits were \$10.8 million and \$5.9 million at December 31, 2013 and 2012, respectively. Of these totals, \$8.4 million and \$3.5 million represent unrecognized tax benefits, net of federal tax benefit and accrued interest expense which, if recognized, would impact the Company's effective tax rate.

Management does not expect the Company's total amount of unrecognized tax benefits to materially increase within the next twelve months related to its ongoing California state tax apportionment factor issues.

The Company recognizes interest and penalties related to unrecognized tax benefits as a part of income taxes. During the years ended December 31, 2013, 2012, and 2011, the Company recognized net interest and penalty expense, excluding refunds, of \$1,119,000, \$111,000, and \$106,000, respectively. The Company carried an accrued interest and penalty balance of \$2,065,000 and \$945,000 at December 31, 2013 and 2012, respectively.

10. Losses and Loss Adjustment Expenses

Activity in the reserves for losses and loss adjustment expenses is summarized as follows:

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Gross reserves at January 1	\$ 1,036,123	\$ 985,279	\$ 1,034,205
Less reinsurance recoverable	(12,155)	(7,921)	(6,805)
Net reserves at January 1	1,023,968	977,358	1,027,400
Incurred losses and loss adjustment expenses related to:			
Current year	1,959,730	1,919,116	1,810,711
Prior years	2,960	42,332	18,494
Total incurred losses and loss adjustment expenses	1,962,690	1,961,448	1,829,205
Loss and loss adjustment expense payments related to:			
Current year	1,354,074	1,314,748	1,265,188
Prior years	607,527	600,090	614,059
Total payments	1,961,601	1,914,838	1,879,247
Net reserves at year-end	1,025,057	1,023,968	977,358
Reinsurance recoverable	13,927	12,155	7,921
Gross reserves at year-end	\$ 1,038,984	\$ 1,036,123	\$ 985,279

The increase in the provision for insured events of prior years in 2013 of approximately \$3 million primarily resulted from Florida claims that were re-opened from prior years due to a state supreme court ruling that was adverse to the insurance industry.

The increase in the provision for insured events of prior years in 2012 of approximately \$42 million primarily resulted from the re-estimate of accident years 2010 and 2011 California BI losses which have experienced higher average severities and more late reported claims than were originally estimated at December 31, 2011. Additionally, the Company experienced unfavorable development on the run-off of California commercial taxi business and Florida homeowners business, both of which the Company ceased writing in 2011. 2012 accident year losses were also impacted by higher loss severity and frequency on the California private passenger automobile line of business.

The increase in the provision for insured events of prior years in 2011 of approximately \$18 million primarily resulted from the re-estimate of accident years 2008 through 2010 California BI losses which have experienced higher average severities than were originally estimated at December 31, 2010. Partially offsetting this increase was favorable development on loss adjustment expenses reflecting cost savings from the transition of a large portion of litigated cases from outside counsel to in-house counsel.

The Company experienced estimated pre-tax losses and loss adjustment expenses from severe weather events of \$17 million, \$39 million, and \$18 million in 2013, 2012, and 2011, respectively. The losses in 2013 were primarily due to tornadoes in Oklahoma and severe storms in the Midwest and the Southeast regions during the second quarter. The losses in 2012 were primarily due to Hurricane Sandy and wind and hail storms in the Midwest region. The losses in 2011 related to California wind storms, Hurricane Irene, and Georgia tornadoes.

11. Dividends

The following table presents shareholder dividends paid in total and per share:

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands, except per share data)		
Total paid	\$ 134,776	\$ 134,105	\$ 132,142
Per share	\$ 2.4525	\$ 2.4425	\$ 2.41

The Insurance Companies are subject to the financial capacity guidelines established by their domiciliary states. The payment of dividends from statutory unassigned surplus of the Insurance Companies is restricted, subject to certain statutory limitations. For 2014, the insurance subsidiaries of the Company are permitted to pay approximately \$260 million in dividends to Mercury General without the prior approval of the DOI of domiciliary states. The above statutory regulations may have the effect of indirectly limiting the ability of the Company to pay shareholder dividends. During 2013, 2012, and 2011, the Insurance Companies paid the Company ordinary dividends of \$120 million, \$145 million, and \$0, respectively, and extraordinary dividends of \$0, \$0, and \$270 million, respectively.

On February 7, 2014, the Board of Directors declared a \$0.6150 quarterly dividend payable on March 31, 2014 to shareholders of record on March 17, 2014.

12. Statutory Balances and Accounting Practices

The Insurance Companies prepare their statutory-basis financial statements in conformity with accounting practices prescribed or permitted by the insurance departments of their domiciliary states. Prescribed statutory accounting practices primarily include those published as statements of statutory accounting principles by the National Association of Insurance Commissioners (the "NAIC"), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed. As of December 31, 2013, there were no material permitted statutory accounting practices utilized by the Insurance Companies.

The following table presents the statutory net income and capital and surplus of the Insurance Companies, as reported to regulatory authorities:

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Statutory net income ⁽¹⁾	\$ 235,251	\$ 63,365	\$ 223,447
Statutory capital and surplus	1,528,682	1,440,973	1,497,609

- (1) Statutory net income excludes changes in the fair value of the investment portfolio as a result of the application of fair value option.

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The RBC formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2013, 2012, and 2011 each of the Insurance Companies exceeded the minimum required RBC levels, as determined by the NAIC and adopted by the state insurance regulators. None of the Insurance Companies' RBC ratio was less than 500% of the authorized control level RBC as of December 31, 2013, 2012, and 2011, respectively. Generally, an RBC ratio of 200% or less would require some form of regulatory or company action.

13. Profit Sharing Plan

The Company's employees are eligible to become members of the Profit Sharing Plan (the "Plan"). The Company, at the option of the Board of Directors, may make annual contributions to the Plan, and the contributions are not to exceed the greater of the Company's net income for the plan year or its retained earnings at that date. In addition, the annual contributions may not exceed an amount equal to 15% of the compensation paid or accrued during the year to all participants under the Plan. No contributions were made in the past three years.

The Plan includes an option for employees to make salary deferrals under Section 401(k) of the Internal Revenue Code. The matching contributions, at a rate set by the Board of Directors, totaled \$8.1 million, \$7.2 million, and \$7.2 million for 2013, 2012, and 2011, respectively.

The Plan also includes an employee stock ownership plan that covers substantially all employees. The Board of Directors authorizes the Plan to purchase the Company's common stock in the open market for allocation to the Plan participants. No purchases were made during the past three years.

14. Share-Based Compensation

In May 2005, the Company adopted the 2005 Plan which succeeded a prior plan. A maximum of 4,897,250 shares of common stock under the 2005 Plan are authorized for issuance upon exercise of options, stock appreciation rights and other awards, or upon vesting of restricted or deferred stock awards. As of December 31, 2013, only options and restricted stock awards have been granted under these plans. Beginning January 1, 2008, options granted, for which the Company has recognized share-based compensation expense become exercisable at a rate of 25% per year beginning one year from the date granted, are granted at the market price on the date of grant, and expire after 10 years. Prior to January 1, 2008, shares became exercisable at a rate of 20% per year.

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Cash received from option exercises	\$ 1,446	\$ 2,492	\$ 1,951
Compensation cost	974	(370)	899
Excess tax benefit	202	86	56

In 2013, the fair value of stock option awards was estimated on the date of grant using a closed-form option valuation model (Black-Scholes) based on the following table, which provides the weighted-average values of assumptions used in the calculation of grand-date fair values during the years ended December 31, 2013. No stock options were awarded in 2012 and 2011.

	2013
Weighted-average grant-date fair value	\$7.11
Expected volatility	33.16% - 33.18%
Weighted-average expected volatility	33.17%
Risk-free interest rate	0.88% - 1.60%
Expected dividend yield	5.40% - 5.76%
Expected term in months	72

Expected volatilities are based on historical volatility of the Company's stock over the term of the options. The Company estimated the expected term of options, which represents the period of time that options granted are expected to be outstanding, by using historical exercise patterns and post-vesting termination behavior. The risk free interest rate is determined based on U.S. Treasury yields with equivalent remaining terms in effect at the time of the grant.

A summary of the stock option activity under the Company's plans as of December 31, 2013 and changes during the year then ended is presented below:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in 000's)
Outstanding at January 1, 2013	451,025	\$ 47.22		
Granted	80,000	\$ 43.53		
Exercised	(86,275)	\$ 33.93		
Canceled or expired	(11,000)	\$ 50.07		
Outstanding at December 31, 2013	433,750	\$ 49.11	4.2	\$ 1,287
Exercisable at December 31, 2013	353,750	\$ 50.37	3.1	\$ 792

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all options been exercised on December 31, 2013. The aggregate intrinsic value of stock options exercised was \$862,000, \$392,000, and \$262,000 during 2013, 2012, and 2011, respectively. The total fair value of options vested was \$146,000, \$407,000, and \$467,000 during 2013, 2012, and 2011, respectively.

The following table presents information regarding stock options outstanding at December 31, 2013:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Options	Weighted-Avg. Remaining Contractual Life (Years)	Weighted-Avg. Exercise Price	Number of Options	Weighted-Avg. Exercise Price
\$33.61-45.30	125,250	8.0	\$ 40.36	45,250	\$ 34.76
\$47.61-51.51	161,000	3.6	\$ 49.70	161,000	\$ 49.70
\$52.13-58.83	147,500	1.9	\$ 55.88	147,500	\$ 55.88

As of December 31, 2013, \$487,000 of total unrecognized compensation cost related to non-vested stock options is expected to be recognized over a weighted-average period of 3.4 years.

Under the 2005 Plan, the Compensation Committee of the Company's Board of Directors granted performance vesting restricted stock units to the Company's senior management and key employees. See Note 1 for grants summary. A summary of the restricted stock unit activity as of December 31, 2013, 2012, and 2011 and changes during the years then ended is as follows:

	2013		2012		2011	
	Shares	Weighted-Average Fair Value per Share	Shares	Weighted-Average Fair Value per Share	Shares	Weighted-Average Fair Value per Share
Outstanding at January 1	169,000	\$ 42.22	135,000	\$ 40.70	55,000	\$ 41.40
Granted	84,500	\$ 36.82	92,000	\$ 44.01	80,000	\$ 40.22
Vested	0		0		0	
Forfeited/Canceled	(3,000)	\$ 36.82	(3,000)	\$ 44.01	0	
Expired	(80,000)	\$ 40.22	(55,000)	\$ 41.40	0	
Outstanding at December 31	170,500	\$ 39.64	169,000	\$ 42.22	135,000	\$ 40.70

15. Earnings Per Share

A reconciliation of the numerators and denominators of the basic and diluted earnings per share calculation for income from operations is presented below:

	2013			2012			2011		
	Income (Numerator)	Weighted Shares (Denominator)	Per- Share Amount	Income (Numerator)	Weighted Shares (Denominator)	Per- Share Amount	Income (Numerator)	Weighted Shares (Denominator)	Per- Share Amount
(Amounts and numbers in thousands, except per-share data)									
Basic EPS									
Income available to common stockholders	\$ 112,143	54,947	\$ 2.04	\$ 116,911	54,899	\$ 2.13	\$ 191,164	54,825	\$ 3.49
Effect of dilutive securities:									
Options	0	17		0	23		0	20	
Diluted EPS									
Income available to common stockholders after assumed conversions	\$ 112,143	54,964	\$ 2.04	\$ 116,911	54,922	\$ 2.13	\$ 191,164	54,845	\$ 3.49

Incremental shares of 421,000, 415,000, and 504,000 for 2013, 2012, and 2011, respectively, were excluded from the computation of the diluted earnings per common shares due to their anti-dilutive effect. Potentially dilutive securities representing approximately 63,000, 80,000, and 103,000 shares of common stock for 2013, 2012, and 2011, respectively, were also excluded from the computation of diluted earnings per common share because their effect would have been anti-dilutive.

16. Commitments and Contingencies

Operating Leases

The Company is obligated under various non-cancellable lease agreements providing for office space, automobiles, and office equipment that expire at various dates through the year 2019. For leases that contain predetermined escalations of the minimum rentals, the Company recognizes the related rent expense on a straight-line basis and records the difference between the recognized rental expense and amounts payable under the leases as deferred rent in other liabilities. This liability amounted to \$3.4 million and \$2.2 million at December 31, 2013 and 2012, respectively. Total rent expense under these lease agreements was \$19.3 million, \$17.7 million, and \$18.2 million for 2013, 2012, and 2011, respectively.

The following table presents future minimum commitments for operating leases as of December 31, 2013:

<u>Year Ending December 31,</u>	<u>Operating Leases</u> <u>(Amounts in thousands)</u>
2014	\$ 13,282
2015	11,214
2016	9,510
2017	7,345
2018	3,112
Thereafter	170

California Earthquake Authority ("CEA")

The CEA is a quasi-governmental organization that was established to provide a market for earthquake coverage to California homeowners. The Company places all new and renewal earthquake coverage offered with its homeowners policies directly with the CEA. The Company receives a small fee for placing business with the CEA, which is recorded as other income in the consolidated statements of operations. Upon the occurrence of a major seismic event, the CEA has the ability to assess participating companies for losses. These assessments are made after CEA capital has been expended and are based upon each company's participation percentage multiplied by the amount of the total assessment. Based upon the most recent information provided by the CEA, the Company's maximum total exposure to CEA assessments at April 1, 2013, the most recent date at which information was available, was approximately \$60.4 million. There was no assessment made in 2013.

Regulatory Matters

In April 2010, the California DOI issued a Notice of Non-Compliance ("2010 NNC") to MIC, MCC, and CAIC based on a Report of Examination of the Rating and Underwriting Practices of these companies issued by the California DOI in February

2010. The 2010 NNC includes allegations of 35 instances of noncompliance with applicable California insurance law and seeks to require that each of MIC, MCC, and CAIC change its rating and underwriting practices to rectify the alleged noncompliance and may also seek monetary penalties. In April 2010, the Company submitted a Statement of Compliance and Notice of Defense to the 2010 NNC, in which it denied the allegations contained in the 2010 NNC and provided specific defenses to each allegation. The Company also requested a hearing in the event that the Statement of Compliance and Notice of Defense does not establish to the satisfaction of the California DOI that the alleged noncompliance does not exist, and the matters described in the 2010 NNC are not otherwise able to be resolved informally with the California DOI. However, no assurance can be given that efforts to resolve the 2010 NNC informally will be successful.

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 seeks to impose a fine for each policy in which the Company allegedly permitted an agent to charge a broker fee and a penalty for each on which the Company allegedly used a misleading advertisement and to suspend certificates of authority for a period of one year. In January 2012, an Administrative Law Judge (“ALJ”) bifurcated the 2004 NNC between (a) the California DOI’s order to show cause, in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI’s notice of noncompliance, in which the California DOI asserts the unlawful rate allegations. In February 2012, the ALJ submitted a proposed decision dismissing the California DOI’s 2004 NNC. In March 2012, the California Insurance Commissioner rejected the ALJ’s proposed decision. The Company challenged the rejection in Superior Court in April 2012. Following a hearing, the Superior Court sustained the California Insurance Commissioner’s demurrer without leave to amend because it found the Company must first exhaust its administrative remedies. In January 2013, the Superior Court’s decision was subsequently affirmed on appeal. In January 2013, the ALJ heard various pending motions that had been filed by the Company in June 2011. The ALJ granted certain portions of the California DOI’s motion for collateral estoppel to prevent the Company from litigating certain findings of fact reached in a prior litigation action and denied the Company’s motion for governmental estoppel and laches, without prejudice, on the ground that a resolution of the motion requires specific factual findings in the context of the evidentiary hearing. The ALJ held an evidentiary hearing on the noncompliance portion of the 2004 NNC during April 2013. A mediation was held in September 2013, but the parties were unable to reach a settlement of the matter. Post-hearing briefs have been filed by the Company, the California DOI, and a consumer group. Until the evidentiary record is closed, there is no set timetable for a decision by the ALJ or, thereafter, a decision by the California Insurance Commissioner.

The Company denies the allegations in the 2004 and 2010 NNC matters, and believes that no monetary penalties are warranted, and the Company intends to defend itself against the allegations vigorously. The Company has been subject to fines and penalties by the California DOI in the past due to alleged violations of the California Insurance Code. The largest and most recent of these was settled in 2008 for \$300,000. However, prior settlement amounts are not necessarily indicative of the potential results in the current notice of non-compliance matters. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the 2004 and 2010 NNC matters will be material to the Company’s financial position. The Company has accrued a liability for the estimated cost to defend itself in the notice of non-compliance matters.

Litigation

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 Note 1.

The Company also 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, results of operations, or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate.

The Company is also involved in proceedings relating to assessments and rulings made by the FTB. See Note 9.

17. Risks and Uncertainties

Many businesses are still experiencing a slow recovery from the severe economic recession. Though optimism is growing, economists and analysts expect that the global recovery will remain modest and uneven in 2014 due in large part to continuing political disagreements in Washington that may cause businesses and consumers to limit spending. Further, softness in the European banking sector and the Japanese fiscal condition continue to lead to weaker global economic growth, heightened financial vulnerabilities and some negative rating actions. The Company is unable to predict the duration and severity of current global economic conditions and their impact on the United States, and California, where the majority of the Company's business is produced. If economic conditions do not show improvement, there could be an adverse impact on the Company's financial condition, results of operations, and liquidity.

The Company applies the fair value option to its investment portfolio. Rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within the Company's financial statements, and the period-to-period changes in value could vary significantly. Decreases in market value may have a material adverse effect on the Company's financial condition or results of operations.

The Company is taking steps to align expenses with revenues; however, not all expenses can be effectively reduced and if premium volumes decline, it could lead to higher expense ratios. The 2013 expense ratio was affected by the consolidation of claims and underwriting operations located outside of California into hub locations, which resulted in approximately \$10 million of pre-tax office closure costs and severance related expense during the first quarter of 2013. The impact from the recession would also affect the capital and surplus of the Insurance Companies, which could indirectly impact the ability and capacity to pay shareholder dividends.

18. Quarterly Financial Information (Unaudited)

Summarized quarterly financial data for 2013 and 2012 are as follows:

	Quarter Ended			
	March 31	June 30	September 30	December 31
	(Amounts in thousands, except per share data)			
<u>2013</u>				
Net premiums earned	\$ 662,595	\$ 675,787	\$ 678,913	\$ 680,892
Change in fair value of investments pursuant to the fair value option	\$ 43,467	\$ (78,726)	\$ 21,815	\$ (30,593)
Income (loss) before income taxes	\$ 90,994	\$ (24,959)	\$ 54,793	\$ 11,268
Net income (loss)	\$ 66,461	\$ (9,264)	\$ 39,570	\$ 15,376
Basic earnings per share	\$ 1.21	\$ (0.17)	\$ 0.72	\$ 0.28
Diluted earnings per share	\$ 1.21	\$ (0.17) ⁽¹⁾	\$ 0.72	\$ 0.28
Dividends paid per share	\$ 0.6125	\$ 0.6125	\$ 0.6125	\$ 0.6150
<u>2012</u>				
Net premiums earned	\$ 635,812	\$ 637,247	\$ 646,084	\$ 655,777
Change in fair value of investments pursuant to the fair value option	\$ 49,343	\$ (24,788)	\$ 44,783	\$ (28,944)
Income (loss) before income taxes	\$ 101,994	\$ (18,853)	\$ 91,330	\$ (39,161)
Net income (loss)	\$ 73,356	\$ (5,264)	\$ 66,201	\$ (17,382)
Basic earnings per share	\$ 1.34	\$ (0.10)	\$ 1.21	\$ (0.32)
Diluted earnings per share	\$ 1.34	\$ (0.10) ⁽¹⁾	\$ 1.21	\$ (0.32) ⁽¹⁾
Dividends paid per share	\$ 0.61	\$ 0.61	\$ 0.61	\$ 0.6125

(1) The dilutive impact of incremental shares is excluded from net loss position in accordance with GAAP.

Net income during 2013 was primarily affected by higher net premiums earned offset by catastrophe related losses, and declines in the fair value of the Company's investment portfolio due to the overall decline in the municipal markets. Net income during 2013 was also affected by the consolidation of claims and underwriting operations located outside of California into hub locations, which resulted in approximately \$10 million of pre-tax office closure costs and severance related expense during the

first quarter of 2013. The primary causes of the net loss during the second quarter of 2013 were driven by increased losses resulting from catastrophe losses due to tornadoes in Oklahoma and severe storms in the Midwest and the Southeast regions, and declines in the fair value of the Company's municipal and equity securities due to the overall decline in the municipal and equity markets.

Net income during 2012 was primarily affected by slightly higher net premiums earned and lower operating expenses, offset by unfavorable development on loss reserves, catastrophe related losses, and higher loss frequency and severity on the California private passenger automobile line of business. The decrease in operating expenses in 2012 was primarily due to ongoing cost reduction efforts and lower profitability related expenses. The unfavorable development of loss reserves is largely the result of re-estimates of California BI losses. The primary causes of the net loss during the second quarter of 2012 were driven by unfavorable development on loss reserves, catastrophe losses in the Midwest region, and declines in the fair value of the Company's equity securities due to the overall decline in the equity markets. The net loss during the fourth quarter of 2012 was primarily due to increased losses resulting from catastrophe losses from Hurricane Sandy, high seasonal frequency in California, and declines in the fair value of the Company's municipal and equity securities due to the overall decline in the municipal and equity markets.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None

Item 9A. 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 Securities and Exchange Commission 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 its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. 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.

Management's Report on Internal Control Over Financial Reporting

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control—Integrated Framework (1992)*. Based upon its assessment, the Company's management believes that, as of December 31, 2013, the Company's internal control over financial reporting is effective based on these criteria.

KPMG LLP, the independent registered public accounting firm that audited the consolidated financial statements included in this 2013 Annual Report on Form 10-K, has issued an audit report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2013, which is included herein.

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.

Item 9B. Other Information

None

PART III

- Item 10. Directors, Executive Officers, and Corporate Governance**
- Item 11. Executive Compensation**
- Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**
- Item 13. Certain Relationships and Related Transactions, and Director Independence**
- Item 14. Principal Accounting Fees and Services**

Information regarding executive officers of the Company is included in Part I. For other information called for by Items 10, 11, 12, 13 and 14, reference is made to the Company's definitive proxy statement for its Annual Meeting of Shareholders, which will be filed with the SEC within 120 days after December 31, 2013 and which is incorporated herein by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules

The following documents are filed as a part of this report:

1. Financial Statements: The Consolidated Financial Statements for the year ended December 31, 2013 are contained herein as listed in the Index to Consolidated Financial Statements on page 50.

2. Financial Statement Schedules:

Report of Independent Registered Public Accounting Firm

Schedule I—Summary of Investments—Other than Investments in Related Parties

Schedule II—Condensed Financial Information of Registrant

Schedule IV—Reinsurance

All other schedules are omitted as the required information is inapplicable or the information is presented in the Consolidated Financial Statements or Notes thereto.

3. Exhibits

- | | |
|------------|---|
| 3.1(1) | Articles of Incorporation of the Company, as amended to date. |
| 3.2(2) | Amended and Restated Bylaws of the Company. |
| 3.3(3) | First Amendment to Amended and Restated Bylaws of the Company. |
| 3.4(4) | Second Amendment to Amended and Restated Bylaws of the Company. |
| 4.1(5) | Shareholders' Agreement dated as of October 7, 1985 among the Company, George Joseph and Gloria Joseph. |
| 10.1(6)* | Profit Sharing Plan, as Amended and Restated as of March 11, 1994. |
| 10.2(7)* | Amendment 1994-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.3(7)* | Amendment 1994-II to the Mercury General Corporation Profit Sharing Plan. |
| 10.4(8)* | Amendment 1996-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.5(8)* | Amendment 1997-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.6(1)* | Amendment 1998-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.7(9)* | Amendment 1999-I and Amendment 1999-II to the Mercury General Corporation Profit Sharing Plan. |
| 10.8(10)* | Amendment 2001-I to the Mercury General Corporation Profit Sharing Plan. |
| 10.9(11)* | Amendment 2002-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.10(11)* | Amendment 2002-2 to the Mercury General Corporation Profit Sharing Plan. |
| 10.11(12)* | Amendment 2003-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.12(12)* | Amendment 2004-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.13(13)* | Amendment 2006-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.14(14)* | Amendment 2006-2 to the Mercury General Corporation Profit Sharing Plan. |
| 10.15(13)* | Amendment 2007-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.16(15)* | Amendment 2008-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.17(15)* | Amendment 2008-2 to the Mercury General Corporation Profit Sharing Plan. |
| 10.18(16)* | Amendment 2009-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.19(16)* | Amendment 2009-2 to the Mercury General Corporation Profit Sharing Plan. |
| 10.20(17)* | Amendment 2011-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.21(18)* | Amendment 2013-1 to the Mercury General Corporation Profit Sharing Plan. |
| 10.22(19) | Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Casualty Company, Mercury Insurance Company, California Automobile Insurance Company and California General Insurance Company. |

10.23(19)	Expense Reimbursement and Services Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and American Mercury Insurance Company.
10.24(19)	Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Georgia.
10.25(19)	Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Georgia.
10.26(19)	Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Illinois.
10.27(19)	Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Illinois.
10.28(10)	Management Agreement effective January 1, 2002 between Mercury Insurance Services, LLC and Mercury Insurance Company of Florida and Mercury Indemnity Company of Florida.
10.29(14)	Management Agreement dated January 22, 1997 between Mercury County Mutual Insurance Company and Mercury Insurance Services, LLC.
10.30	Director Compensation Arrangements.
10.31(20)*	Mercury General Corporation Senior Executive Incentive Bonus Plan.
10.32(21)*	Amended and Restated Mercury General Corporation 2005 Equity Incentive Award Plan.
10.33(22)*	Incentive Stock Option Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan.
10.34(23)*	Restricted Stock Unit Award Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan.
10.35(24)	Credit Agreement, dated as of January 2, 2009, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto.
10.36(15)	Amendment Agreement to Credit Agreement, dated as of January 26, 2009, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto.
10.37(25)	Second Amendment Agreement to Credit Agreement, dated as of August 4, 2011, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto.
10.38(26)	Third Amendment Agreement to Credit Agreement, dated as of July 31, 2013, among Mercury Casualty Company, Mercury General Corporation, Bank of America, N.A., and the lenders party thereto.
10.39(27)*	Mercury General Corporation Annual Incentive Plan.
10.40(28)	Credit Agreement, dated as of July 2, 2013, by and among Mercury General Corporation, Bank of America, as Administrative Agent, and the Lenders party thereto.
21.1	Subsidiaries of the Company.
23.1	Consent 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 Annual Report on Form 10-K 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 Annual Report on Form 10-K 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

- (1) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1997, and is incorporated herein by this reference.
- (2) This document was filed as an exhibit to Registrant's Form 10-Q for the quarterly period ended September 30, 2007, and is incorporated herein by this reference.
- (3) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 4, 2008, and is incorporated herein by this reference.
- (4) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on February 25, 2009, and is incorporated herein by this reference.
- (5) This document was filed as an exhibit to Registrant's Registration Statement on Form S-1, File No. 33-899, and is incorporated herein by this reference.
- (6) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1993, and is incorporated herein by this reference.
- (7) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1994, and is incorporated herein by this reference.
- (8) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1996, and is incorporated herein by this reference.
- (9) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1999, and is incorporated herein by this reference.
- (10) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2001, and is incorporated herein by this reference.
- (11) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2002, and is incorporated herein by this reference.
- (12) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2004, and is incorporated herein by this reference.
- (13) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2007, and is incorporated herein by this reference.
- (14) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2006, and is incorporated herein by this reference.
- (15) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2008, and is incorporated herein by this reference.
- (16) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2009, and is incorporated herein by this reference.
- (17) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2011, and is incorporated herein by this reference.
- (18) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2013, and is incorporated herein by this reference.
- (19) This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.
- (20) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 8, 2013, and is incorporated herein by this reference.
- (21) This document was filed as an exhibit to the Registrant's Form 8-K filed with the Securities and Exchange Commission on November 1, 2010, and is incorporated herein by this reference.
- (22) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 16, 2005, and is incorporated herein by this reference.
- (23) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on October 5, 2010, and is incorporated herein by this reference.
- (24) This document was filed as an exhibit to Registrant's Form 10-Q for the quarterly period ended June 30, 2008, and is incorporated herein by this reference.
- (25) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 5, 2011, and is incorporated herein by this reference.
- (26) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 5, 2013, and is incorporated herein by this reference.
- (27) This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities Exchange Commission on May 2, 2011, and is incorporated herein by this reference.
- (28) This document was filed as an exhibit to Registrant's Form 10-Q for the quarterly period ended June 30, 2013, and is incorporated herein by this reference.

* Denotes management contract or compensatory plan or arrangement.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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

BY /s/ GABRIEL TIRADOR
Gabriel Tirador
President and Chief Executive Officer

February 10, 2014

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/S/ GEORGE JOSEPH</u> George Joseph	Chairman of the Board	February 10, 2014
<u>/S/ GABRIEL TIRADOR</u> Gabriel Tirador	President and Chief Executive Officer and Director (Principal Executive Officer)	February 10, 2014
<u>/S/ THEODORE R. STALICK</u> Theodore R. Stalick	Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 10, 2014
<u>/S/ BRUCE A. BUNNER</u> Bruce A. Bunner	Director	February 10, 2014
<u>/S/ MICHAEL D. CURTIUS</u> Michael D. Curtius	Director	February 10, 2014
<u>/S/ CHRISTOPHER GRAVES</u> Christopher Graves	Director	February 10, 2014
<u>/S/ RICHARD E. GRAYSON</u> Richard E. Grayson	Director	February 10, 2014
<u>/S/ MARTHA E. MARCON</u> Martha E. Marcon	Director	February 10, 2014
<u>/S/ DONALD P. NEWELL</u> Donald P. Newell	Director	February 10, 2014
<u>/S/ DONALD R. SPUEHLER</u> Donald R. Spuehler	Director	February 10, 2014

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
Mercury General Corporation:

Under date of February 10, 2014, we reported on the consolidated balance sheets of Mercury General Corporation and subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013, as contained in the Annual Report on Form 10-K for the year 2013. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related financial statement schedules in the accompanying index. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits.

In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Los Angeles, California
February 10, 2014

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
SUMMARY OF INVESTMENTS
OTHER THAN INVESTMENTS IN RELATED PARTIES
DECEMBER 31, 2013

<u>Type of Investment</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Amounts in the Balance Sheet</u>
	<u>(Amounts in thousands)</u>		
Fixed maturity securities:			
U.S. government bonds and agencies	\$ 15,994	\$ 16,096	\$ 16,096
Municipal securities	2,201,047	2,235,323	2,235,323
Mortgage-backed securities	37,848	40,247	40,247
Corporate securities	264,172	264,685	264,685
Collateralized debt obligations	3,981	4,302	4,302
Total fixed maturity securities	<u>2,523,042</u>	<u>2,560,653</u>	<u>2,560,653</u>
Equity securities:			
Common stock:			
Public utilities	81,128	85,287	85,287
Banks, trust and insurance companies	1,610	2,927	2,927
Energy and other	101,455	151,554	151,554
Non-redeemable preferred stock	29,740	29,567	29,567
Partnership interest in a private credit fund	10,000	12,548	12,548
Total equity securities	<u>223,933</u>	<u>281,883</u>	<u>281,883</u>
Short-term investments	<u>315,886</u>	<u>315,776</u>	<u>315,776</u>
Total investments	<u>\$ 3,062,861</u>	<u>\$ 3,158,312</u>	<u>\$ 3,158,312</u>

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
SUMMARY OF INVESTMENTS
OTHER THAN INVESTMENTS IN RELATED PARTIES
DECEMBER 31, 2012

<u>Type of Investment</u>	<u>Cost</u>	<u>Fair Value</u>	<u>Amounts in the Balance Sheet</u>
	<u>(Amounts in thousands)</u>		
Fixed maturity securities:			
U.S. government bonds and agencies	\$ 13,999	\$ 14,204	\$ 14,204
Municipal securities	2,040,537	2,165,095	2,165,095
Mortgage-backed securities	27,786	30,703	30,703
Corporate securities	151,019	155,551	155,551
Collateralized debt obligations	37,562	42,801	42,801
Total fixed maturity securities	<u>2,270,903</u>	<u>2,408,354</u>	<u>2,408,354</u>
Equity securities:			
Common stock:			
Public utilities	82,474	85,106	85,106
Banks, trust and insurance companies	19,701	22,166	22,166
Energy and other	352,889	346,809	346,809
Non-redeemable preferred stock	10,895	11,701	11,701
Partnership interest in a private credit fund	10,000	11,306	11,306
Total equity securities	<u>475,959</u>	<u>477,088</u>	<u>477,088</u>
Short-term investments	<u>294,607</u>	<u>294,653</u>	<u>294,653</u>
Total investments	<u>\$ 3,041,469</u>	<u>\$ 3,180,095</u>	<u>\$ 3,180,095</u>

MERCURY GENERAL CORPORATION
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
BALANCE SHEETS

	December 31,	
	2013	2012
	(Amounts in thousands)	
ASSETS		
Investments, at fair value:		
Equity securities (cost \$27,449; \$31,178)	\$ 29,737	\$ 27,127
Short-term investments (cost \$11,089; \$47,174)	11,089	47,174
Investment in subsidiaries	1,794,164	1,760,760
Total investments	1,834,990	1,835,061
Cash	46,332	10,199
Accrued investment income	16	4
Amounts receivable from affiliates	206	200
Current income taxes	0	6,333
Deferred income taxes	1,068	729
Income tax receivable from affiliates	11,573	6,182
Other assets	459	0
Total assets	\$ 1,894,644	\$ 1,858,708
LIABILITIES AND SHAREHOLDERS' EQUITY		
Notes payable	\$ 50,000	\$ 0
Accounts payable and accrued expenses	23	47
Amounts payable to affiliates	34	95
Income tax payable to affiliates	6,730	16,069
Current income taxes	12,672	0
Other liabilities	2,699	0
Total liabilities	72,158	16,211
Shareholders' equity:		
Common stock	81,591	79,380
Additional paid-in capital	411	0
Retained earnings	1,740,484	1,763,117
Total shareholders' equity	1,822,486	1,842,497
Total liabilities and shareholders' equity	\$ 1,894,644	\$ 1,858,708

MERCURY GENERAL CORPORATION
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Revenues:			
Net investment income	\$ 1,293	\$ 1,114	\$ 1,411
Net realized investment gains (losses)	3,416	697	(1,866)
Total revenues	<u>4,709</u>	<u>1,811</u>	<u>(455)</u>
Expenses:			
Other operating expenses	2,924	1,688	2,267
Interest	318	0	1,341
Total expenses	<u>3,242</u>	<u>1,688</u>	<u>3,608</u>
Income (loss) before income taxes and equity in net income of subsidiaries	1,467	123	(4,063)
Income tax expense (benefit)	3,310	1,800	(684)
Loss before equity in net income of subsidiaries	<u>(1,843)</u>	<u>(1,677)</u>	<u>(3,379)</u>
Equity in net income of subsidiaries	113,986	118,588	194,543
Net income	<u>\$ 112,143</u>	<u>\$ 116,911</u>	<u>\$ 191,164</u>

STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Net income	\$ 112,143	\$ 116,911	\$ 191,164
Other comprehensive income, before tax:			
Gains on hedging instrument	0	0	1,139
Other comprehensive income, before tax	<u>0</u>	<u>0</u>	<u>1,139</u>
Income tax expense related to gains on hedging instrument	0	0	399
Other comprehensive income, net of tax:	<u>0</u>	<u>0</u>	<u>740</u>
Comprehensive income	<u>\$ 112,143</u>	<u>\$ 116,911</u>	<u>\$ 191,904</u>

MERCURY GENERAL CORPORATION
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2013	2012	2011
	(Amounts in thousands)		
Cash flows from operating activities:			
Net cash used in operating activities	\$ (843)	\$ (5,590)	\$ (312)
Cash flows from investing activities:			
Capital contribution to controlled entities	(40,000)	0	0
Dividends from subsidiaries	120,000	145,000	270,000
Equity securities:			
Purchases	(25,038)	(14,102)	(50,056)
Sales	25,798	7,308	43,520
Increase in payable for securities, net	2,489	0	0
Net decrease (increase) in short-term investments	36,085	(20,413)	(21,451)
Other, net	770	304	1,047
Net cash provided by investing activities	120,104	118,097	243,060
Cash flows from financing activities:			
Dividends paid to shareholders	(134,776)	(134,105)	(132,142)
Excess tax benefit from exercise of stock options	202	86	56
Payment to retire senior notes	0	0	(125,000)
Proceeds from stock options exercised	1,446	2,492	1,951
Proceeds from bank loan	50,000	0	0
Net cash used in financing activities	(83,128)	(131,527)	(255,135)
Net increase (decrease) in cash	36,133	(19,020)	(12,387)
Cash:			
Beginning of year	10,199	29,219	41,606
End of year	\$ 46,332	\$ 10,199	\$ 29,219
SUPPLEMENTAL CASH FLOW DISCLOSURE			
Interest paid	\$ 318	\$ 0	\$ 1,932
Income taxes (received) paid	\$ (827)	\$ 4,667	\$ (1,252)

MERCURY GENERAL CORPORATION
CONDENSED FINANCIAL INFORMATION OF REGISTRANT
NOTES TO CONDENSED FINANCIAL INFORMATION

The accompanying condensed financial information should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in this report.

Dividends

Dividends of \$120,000,000, \$145,000,000 and \$270,000,000 were received by Mercury General from its 100% owned subsidiaries in 2013, 2012, and 2011, respectively, and are recorded as a reduction to investment in subsidiaries.

Capitalization of Subsidiaries

Mercury General made capital contributions to its insurance subsidiaries of \$125,000 in each of 2013, 2012, and 2011.

Notes Payable

The borrowings by MCC, a subsidiary, under the \$120 million credit facility and \$20 million bank loan are secured by approximately \$177 million of municipal bonds owned by MCC, at fair value, held as collateral. The total borrowings of \$140 million are guaranteed by the Company.

On July 2, 2013, Mercury General entered into an unsecured \$200 million five-year revolving credit facility. Total borrowings were \$50 million as of December 31, 2013.

Federal Income Taxes

The Company files a consolidated federal income tax return with the following entities:

Mercury Casualty Company	Mercury County Mutual Insurance Company
Mercury Insurance Company	Mercury Insurance Company of Florida
California Automobile Insurance Company	Mercury Indemnity Company of America
California General Underwriters Insurance Company, Inc.	Mercury Select Management Company, Inc.
Mercury Insurance Company of Illinois	Mercury Insurance Services LLC
Mercury Insurance Company of Georgia	AIS Management LLC
Mercury Indemnity Company of Georgia	Auto Insurance Specialists LLC
Mercury National Insurance Company	PoliSeek AIS Insurance Solutions, Inc.
American Mercury Insurance Company	Animas Funding LLC
American Mercury Lloyds Insurance Company	

The method of allocation between the companies is subject to an agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses incurred by the insurance subsidiaries to the extent it can be used in the current consolidated return.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES

REINSURANCE

THREE YEARS ENDED DECEMBER 31,

Property and Liability Insurance Earned Premiums

	2013	2012	2011
	(Amounts in thousands)		
Direct amounts	\$ 2,704,401	\$ 2,578,715	\$ 2,569,661
Ceded to other companies	(7,059)	(5,066)	(4,134)
Assumed	845	1,271	530
Net amounts	<u>\$ 2,698,187</u>	<u>\$ 2,574,920</u>	<u>\$ 2,566,057</u>

Corporate Information

MERCURY GENERAL CORPORATION

Corporate Headquarters
4484 Wilshire Boulevard
Los Angeles, California 90010
Telephone: (323) 937-1060
Fax: (323) 857-7116

SUBSIDIARIES

Mercury Casualty Company
Mercury Insurance Company
Mercury Insurance Company of Illinois
Mercury Insurance Company of Georgia
Mercury Indemnity Company of Georgia
Mercury Insurance Company of Florida
Mercury Indemnity Company of America
Mercury National Insurance Company
California Automobile Insurance Company
California General Underwriters Insurance Company, Inc.
Concord Insurance Services, Inc.**
Mercury Insurance Services LLC
Mercury County Mutual Insurance Company*
American Mercury Insurance Company
American Mercury Lloyds Insurance Company*
Mercury Select Management Company, Inc.
Auto Insurance Specialists LLC
AIS Management LLC
PoliSeek AIS Insurance Solutions, Inc.
Animas Funding LLC

*Controlled by Mercury General Corporation

**Dissolved in 2013

CORPORATE COUNSEL

Latham & Watkins LLP
Los Angeles, California

INDEPENDENT AUDITORS

KPMG LLP
Los Angeles, California

TRANSFER AGENT & REGISTRAR

Computershare Trust Company, N.A.
250 Royall Street
Canton, MA 02021
Telephone number: (866) 214-7508
Website: www.computershare.com/investor

SHAREHOLDER COMMUNICATIONS

For access to all news releases and other relevant Company information, visit the Mercury General Corporation website at www.mercuryinsurance.com. To request an investor package, please call (323) 857-7123.

ANNUAL MEETING

The Annual Meeting of the Shareholders of Mercury General Corporation will be held on May 14, 2014 at 10:00 a.m. at The Wilshire Country Club, 301 North Rossmore Avenue, Los Angeles, California. There were approximately 133 holders of record on February 3, 2014.

SEC FORM 10-K

Additional copies of this report, which includes the Company's annual report filed with the Securities and Exchange Commission on Form 10-K, will be made available, without charge, upon written request to the Company's Chief Financial Officer at the corporate headquarters or on the website at www.mercuryinsurance.com.



Environmental Benefits Statement

To minimize our environmental impact, the Mercury General Corporation 2013 Annual Report was printed on paper containing fibers from environmentally appropriate, socially beneficial and economically viable forest resources.

