

Edgar Filing: First American Financial Corp - Form 10-Q

First American Financial Corp  
Form 10-Q  
October 20, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-34580

Edgar Filing: First American Financial Corp - Form 10-Q

FIRST AMERICAN FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Incorporated in Delaware (State or other jurisdiction of incorporation or organization)	26-1911571 (I.R.S. Employer Identification No.)
1 First American Way, Santa Ana, California (Address of principal executive offices)	92707-5913 (Zip Code)

(714) 250-3000

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

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 1

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

Large accelerated filer	Accelerated filer	1
-------------------------	-------------------	---

Non-accelerated filer	1	(Do not check if a smaller reporting company)	Smaller reporting company	1
-----------------------	---	---	---------------------------	---

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes 1 No

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Edgar Filing: First American Financial Corp - Form 10-Q

Indicate by check mark whether the registrant has filed all documents and reports to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ☐ No ☒

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

On October 14, 2016, there were 109,820,934 shares of common stock outstanding.

---

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

INFORMATION INCLUDED IN REPORT

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

A. Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015 5

B. Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2016 and 2015 6

C. Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016 and 2015 7

D. Condensed Consolidated Statement of Stockholders' Equity for the nine months ended September 30, 2016 8

E. Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015 9

F. Notes to Condensed Consolidated Financial Statements 10

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 34

Item 3. Quantitative and Qualitative Disclosures About Market Risk 46

Item 4. Controls and Procedures 46

PART II: OTHER INFORMATION

Item 1. Legal Proceedings 46

Item 1A. Risk Factors 48

Item 6. Exhibits 54

Items 2 through 5 of Part II have been omitted because they are not applicable with respect to the current reporting period.



THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS 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 CAN BE IDENTIFIED BY THE FACT THAT THEY DO NOT RELATE STRICTLY TO HISTORICAL OR CURRENT FACTS AND MAY CONTAIN THE WORDS “BELIEVE,” “ANTICIPATE,” “EXPECT,” “INTEND,” “PLAN,” “PREDICT,” “ESTIMATE,” “PROJECT,” “WILL BE,” “WILL CONTINUE,” “WILL LIKELY RESULT,” “MAY,” “MIGHT,” “SHOULD,” “WOULD,” OR “COULD.” THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS REGARDING FUTURE OPERATIONS, PERFORMANCE, FINANCIAL CONDITION, PROSPECTS, PLANS AND STRATEGIES. THESE FORWARD-LOOKING STATEMENTS ARE BASED ON CURRENT EXPECTATIONS AND ASSUMPTIONS THAT MAY PROVE TO BE INCORRECT.

RISKS AND UNCERTAINTIES EXIST THAT MAY CAUSE RESULTS TO DIFFER MATERIALLY FROM THOSE SET FORTH IN THESE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE THE ANTICIPATED RESULTS TO DIFFER FROM THOSE DESCRIBED IN THE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION:

- INTEREST RATE FLUCTUATIONS;
- CHANGES IN THE PERFORMANCE OF THE REAL ESTATE MARKETS;
- VOLATILITY IN THE CAPITAL MARKETS;
- UNFAVORABLE ECONOMIC CONDITIONS;
- IMPAIRMENTS IN THE COMPANY’S GOODWILL OR OTHER INTANGIBLE ASSETS;
- FAILURES AT FINANCIAL INSTITUTIONS WHERE THE COMPANY DEPOSITS FUNDS;
- CHANGES IN APPLICABLE GOVERNMENT REGULATIONS;
- HEIGHTENED SCRUTINY BY LEGISLATORS AND REGULATORS OF THE COMPANY’S TITLE INSURANCE AND SERVICES SEGMENT AND CERTAIN OTHER OF THE COMPANY’S BUSINESSES;
- THE CONSUMER FINANCIAL PROTECTION BUREAU’S EXERCISE OF ITS BROAD RULEMAKING AND SUPERVISORY POWERS;
- REGULATION OF TITLE INSURANCE RATES;
- REFORM OF GOVERNMENT-SPONSORED MORTGAGE ENTERPRISES;
- LIMITATIONS ON ACCESS TO PUBLIC RECORDS AND OTHER DATA;
- CHANGES IN RELATIONSHIPS WITH LARGE MORTGAGE LENDERS AND GOVERNMENT-SPONSORED ENTERPRISES;
- CHANGES IN MEASURES OF THE STRENGTH OF THE COMPANY’S TITLE INSURANCE UNDERWRITERS, INCLUDING RATINGS AND STATUTORY CAPITAL AND SURPLUS;
- LOSSES IN THE COMPANY’S INVESTMENT PORTFOLIO;
- MATERIAL VARIANCE BETWEEN ACTUAL AND EXPECTED CLAIMS EXPERIENCE;
- DEFALCATIONS, INCREASED CLAIMS OR OTHER COSTS AND EXPENSES ATTRIBUTABLE TO THE COMPANY’S USE OF TITLE AGENTS;
- ANY INADEQUACY IN THE COMPANY’S RISK MITIGATION EFFORTS;
- SYSTEMS DAMAGE, FAILURES, INTERRUPTIONS AND INTRUSIONS, OR UNAUTHORIZED DATA DISCLOSURES;
- ERRORS AND FRAUD INVOLVING THE TRANSFER OF FUNDS;
- INABILITY TO REALIZE THE BENEFITS OF THE COMPANY’S OFFSHORE OPERATIONS;
- INABILITY OF THE COMPANY’S SUBSIDIARIES TO PAY DIVIDENDS OR REPAY FUNDS;

INABILITY TO REALIZE THE BENEFITS OF, AND CHALLENGES ARISING FROM, THE COMPANY'S ACQUISITION STRATEGY; AND  
OTHER FACTORS DESCRIBED IN THIS QUARTERLY REPORT ON FORM 10-Q, INCLUDING UNDER THE CAPTION "RISK FACTORS" IN ITEM 1A OF PART II.  
THE FORWARD-LOOKING STATEMENTS SPEAK ONLY AS OF THE DATE THEY ARE MADE. THE COMPANY DOES NOT UNDERTAKE TO UPDATE FORWARD-LOOKING STATEMENTS TO REFLECT CIRCUMSTANCES OR EVENTS THAT OCCUR AFTER THE DATE THE FORWARD-LOOKING STATEMENTS ARE MADE.

## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Balance Sheets

(in thousands, except par values)

(unaudited)

	September 30,  2016	December 31,  2015
<b>Assets</b>		
Cash and cash equivalents	\$1,443,312	\$1,027,321
Accounts and accrued income receivable, net	327,109	256,731
Income taxes receivable	2,740	1,067
Investments:		
Deposits with banks	22,257	23,224
Debt securities, includes pledged securities of \$117,294 and \$122,441	4,592,170	4,279,347
Equity securities	387,921	321,285
Other investments	157,260	161,177
	5,159,608	4,785,033
Property and equipment, net	430,631	409,973
Title plants and other indexes	588,593	554,923
Deferred income taxes	22,020	22,020
Goodwill	1,014,764	964,342
Other intangible assets, net	51,417	48,114
Other assets	206,283	180,777
	\$9,246,477	\$8,250,301
<b>Liabilities and Equity</b>		
Deposits	\$3,218,128	\$2,699,015
Accounts payable and accrued liabilities	813,943	876,087
Deferred revenue	230,747	207,929
Reserve for known and incurred but not reported claims	1,018,040	983,880
Income taxes payable	66,025	7,576
Deferred income taxes	133,097	133,097
Notes and contracts payable	737,944	581,052
	6,217,924	5,488,636
<b>Commitments and contingencies (Note 14)</b>		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.00001 par value; Authorized—500 shares;		
Outstanding—none	—	—



Edgar Filing: First American Financial Corp - Form 10-Q

Common stock, \$0.00001 par value; Authorized—300,000 shares; Outstanding—109,820 shares and 109,098 shares	1	1
Additional paid-in capital	2,182,879	2,150,813
Retained earnings	1,012,452	846,691
Accumulated other comprehensive loss	(173,052 )	(239,003 )
Total stockholders' equity	3,022,280	2,758,502
Noncontrolling interests	6,273	3,163
Total equity	3,028,553	2,761,665
	\$9,246,477	\$8,250,301

See notes to condensed consolidated financial statements.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Statements of Income

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
<b>Revenues</b>				
Direct premiums and escrow fees	\$649,726	\$605,450	\$1,775,615	\$1,716,468
Agent premiums	625,953	585,974	1,653,990	1,520,507
Information and other	188,727	173,349	526,575	511,334
Net investment income	34,422	22,272	92,717	70,694
Net realized investment gains (losses)	9,516	(3,130)	22,692	(215)
	1,508,344	1,383,915	4,071,589	3,818,788
<b>Expenses</b>				
Personnel costs	438,692	411,743	1,239,129	1,185,318
Premiums retained by agents	495,130	462,535	1,303,838	1,200,549
Other operating expenses	219,959	209,316	622,995	621,298
Provision for policy losses and other claims	137,015	139,126	366,473	363,550
Depreciation and amortization	24,491	21,072	70,905	63,389
Premium taxes	18,288	17,439	48,692	46,920
Interest	7,838	7,288	23,427	21,798
	1,341,413	1,268,519	3,675,459	3,502,822
Income before income taxes	166,931	115,396	396,130	315,966
Income taxes	59,539	39,637	133,615	108,831
Net income	107,392	75,759	262,515	207,135
Less: Net income attributable to noncontrolling interests	72	217	545	615
Net income attributable to the Company	\$107,320	\$75,542	\$261,970	\$206,520
Net income per share attributable to the Company's stockholders (Note 9):				
Basic	\$0.97	\$0.69	\$2.37	\$1.91
Diluted	\$0.96	\$0.69	\$2.36	\$1.88
Cash dividends declared per share	\$0.34	\$0.25	\$0.86	\$0.75
Weighted-average common shares outstanding (Note 9):				
Basic	110,571	108,647	110,423	108,284
Diluted	111,251	110,004	111,006	109,706

See notes to condensed consolidated financial statements.



FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Comprehensive Income

(in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	\$107,392	\$75,759	\$262,515	\$207,135
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities	2,579	(10,942)	52,087	(19,374 )
Foreign currency translation adjustment	(3,459 )	(15,416)	3,066	(29,210 )
Pension benefit adjustment	3,602	4,058	10,819	13,260
Total other comprehensive income (loss), net of tax	2,722	(22,300)	65,972	(35,324 )
Comprehensive income	110,114	53,459	328,487	171,811
Less: Comprehensive income attributable to noncontrolling interests	77	206	566	598
Comprehensive income attributable to the Company	\$110,037	\$53,253	\$327,921	\$171,213

See notes to condensed consolidated financial statements.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Condensed Consolidated Statement of Stockholders' Equity

(in thousands)

(unaudited)

First American Financial Corporation Stockholders								
	Shares	Common	paid-in stock capital	Retained earnings	Accumulated other comprehensive loss	Total stockholders' equity	Noncontrolling interests	Total
Balance at December 31, 2015	109,098	\$ 1	\$ 2,150,813	\$ 846,691	\$(239,003)	\$ 2,758,502	\$ 3,163	\$ 2,761,665
Net income for nine months ended September 30, 2016	—	—	—	261,970	—	261,970	545	262,515
Dividends on common shares	—	—	—	(94,202 )	—	(94,202 )	—	(94,202 )
Purchase of Company shares	(14 )	—	(454 )	—	—	(454 )	—	(454 )
Shares issued in connection with share-based compensation plans	736	—	4,450	(2,007 )	—	2,443	—	2,443
Share-based compensation	—	—	28,096	—	—	28,096	—	28,096
Net activity related to noncontrolling interests	—	—	(26 )	—	—	(26 )	2,544	2,518
Other comprehensive income (Note 13)	—	—	—	—	65,951	65,951	21	65,972
Balance at September 30, 2016	109,820	\$ 1	\$ 2,182,879	\$ 1,012,452	\$(173,052)	\$ 3,022,280	\$ 6,273	\$ 3,028,553

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	\$262,515	\$207,135
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for policy losses and other claims	366,473	363,550
Depreciation and amortization	70,905	63,389
Amortization of premiums and accretion of discounts on debt securities, net	20,267	21,702
Excess tax benefits from share-based compensation	(3,197 )	(8,496 )
Net realized investment (gains) losses	(22,692 )	215
Share-based compensation	28,096	20,261
Equity in earnings of affiliates, net	(5,771 )	(7,710 )
Dividends from equity method investments	7,953	7,559
Changes in assets and liabilities excluding effects of acquisitions and noncash transactions:		
Claims paid, including assets acquired, net of recoveries	(351,349 )	(364,255 )
Net change in income tax accounts	20,765	56,784
Increase in accounts and accrued income receivable	(43,454 )	(32,194 )
Decrease in accounts payable and accrued liabilities	(99,777 )	(7,074 )
Increase in deferred revenue	23,342	12,049
Other, net	(21,857 )	19,282
Cash provided by operating activities	252,219	352,197
Cash flows from investing activities:		
Net cash effect of acquisitions/dispositions	(73,173 )	(26,662 )
Net decrease in deposits with banks	608	2,471
Purchases of debt and equity securities	(1,490,824 )	(1,726,939 )
Proceeds from sales of debt and equity securities	494,717	443,276
Proceeds from maturities of debt securities	744,411	531,440
Net change in other investments	2,798	470
Capital expenditures	(103,735 )	(91,964 )
Proceeds from sales of property and equipment	9,218	17,057
Cash used for investing activities	(415,980 )	(850,851 )
Cash flows from financing activities:		
Net change in deposits	519,113	288,495
Net proceeds from issuance of debt	160,000	—
Repayment of debt	(3,745 )	(4,087 )

Edgar Filing: First American Financial Corp - Form 10-Q

Net activity related to noncontrolling interests	(1,004 )	(705 )
Excess tax benefits from share-based compensation	3,197	8,496
Net payments in connection with share-based compensation plans	(754 )	(1,534 )
Purchase of Company shares	(454 )	—
Cash dividends	(94,202 )	(81,283 )
Cash provided by financing activities	582,151	209,382
Effect of exchange rate changes on cash	(2,399 )	(6,378 )
Net increase (decrease) in cash and cash equivalents	415,991	(295,650 )
Cash and cash equivalents—Beginning of period	1,027,321	1,190,080
Cash and cash equivalents—End of period	\$1,443,312	\$894,430
Supplemental information:		
Cash paid during the period for:		
Interest	\$21,097	\$21,166
Premium taxes	\$54,151	\$45,683
Income taxes, less refunds of \$2,731 and \$711	\$112,401	\$52,069

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements

(unaudited)

Note 1 – Basis of Condensed Consolidated Financial Statements

Basis of Presentation

The condensed consolidated financial information included in this report has been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and Article 10 of Securities and Exchange Commission (“SEC”) Regulation S-X. The principles for condensed interim financial information do not require the inclusion of all the information and footnotes required by GAAP for complete financial statements. Therefore, these financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015. The condensed consolidated financial statements included herein are unaudited; however, in the opinion of management, they contain all normal recurring adjustments necessary for a fair statement of the consolidated results for the interim periods. All material intercompany transactions and balances have been eliminated upon consolidation.

Reclassifications and revisions

Certain 2015 amounts have been reclassified to conform to the 2016 presentation.

During the fourth quarter of 2015, the Company reclassified certain revenues and expenses related to closing protection letters and temporary labor costs. The impact to the Company’s title insurance and services segment for the three and nine months ended September 30, 2015 included decreases to direct premiums and escrow fees and increases to agent premiums of \$9.5 million and \$24.6 million, increases to personnel costs of \$10.6 million and \$29.0 million, increases to premiums retained by agents of \$0.5 million and \$1.2 million and decreases to other operating expenses of \$11.1 million and \$30.2 million, respectively. The impact to the Company’s specialty insurance segment for the three and nine months ended September 30, 2015 included increases to personnel costs and decreases to other operating expenses of \$0.2 million and \$0.7 million, respectively.

Also, during the fourth quarter of 2015, the Company identified certain non-risk based revenues included within direct premiums and escrow fees that should have been reflected in information and other. To correct for this error, these revenues were reclassified from direct premiums and escrow fees to information and other. The revision to the Company’s title insurance and services segment for the three and nine months ended September 30, 2015 resulted in a decrease to direct premiums and escrow fees and an increase to information and other of \$10.7 million and \$31.5 million, respectively.



The Company does not consider these adjustments to be material, individually or in the aggregate, to any previously issued consolidated financial statements.

#### Recently Adopted Accounting Pronouncements

In September 2015, the Financial Accounting Standards Board (“FASB”) issued updated guidance intended to simplify the accounting for adjustments made to provisional amounts recognized in a business combination and eliminates the requirement to retrospectively account for those adjustments. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015 and applies prospectively to adjustments made to provisional amounts that occur after the effective date of this guidance with early adoption permitted for financial statements that have not been issued. The adoption of this guidance had no impact on the Company’s condensed consolidated financial statements.

In August 2015, the FASB issued updated guidance relating to the Securities and Exchange Commission Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting on the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements. The updated guidance allows for the deferral and presentation of debt issuance costs as an asset which may be amortized ratably over the term of the line-of-credit arrangement, regardless of whether there are any related outstanding borrowings. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company’s condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

In May 2015, the FASB issued updated guidance intended to eliminate the diversity in practice surrounding how investments measured at net asset value under the practical expedient with future redemption dates have been categorized in the fair value hierarchy. Under the updated guidance, investments for which fair value is measured at net asset value per share using the practical expedient should no longer be categorized in the fair value hierarchy. The updated guidance requires retrospective adoption for all periods presented and is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In April 2015, the FASB issued updated guidance intended to clarify the accounting treatment for cloud computing arrangements that include software licenses. Under the updated guidance, if a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The Company elected to adopt the updated guidance prospectively for all arrangements entered into or materially modified after the effective date. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements. The financial statement line items impacted by the adoption of the updated guidance include other intangible assets, net and depreciation and amortization. See Note 5 Other Intangible Assets for further information on the Company's internal-use software licenses.

In April 2015, the FASB issued updated guidance intended to simplify, and provide consistency to, the presentation of debt issuance costs. The new standard requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements.

In February 2015, the FASB issued updated guidance which changes the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In June 2014, the FASB issued updated guidance intended to eliminate the diversity in practice regarding share-based payment awards that include terms which provide for a performance target that affects vesting being achieved after the requisite service period. The new standard requires that a performance target which affects vesting and could be achieved after the requisite service period be treated as a performance condition that affects vesting and should not be reflected in estimating the grant-date fair value. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

Pending Accounting Pronouncements

In August 2016, the FASB issued updated guidance intended to eliminate the diversity in practice regarding the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated statement of cash flows.

In June 2016, the FASB issued updated guidance intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The updated guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires the consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

In May 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance includes narrow-scope improvements intended to address implementation issues and to provide additional practical expedients in the guidance. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In April 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance is intended to reduce the cost and complexity of applying the guidance on identifying promised goods or services in a contract and to improve the operability and understandability of the implementation guidance regarding the licensing of intellectual property. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to simplify and improve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of such awards as either equity or liabilities and classification on the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance is intended to improve the operability and understandability of the implementation guidance regarding principal versus agent considerations in a contract. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to simplify the accounting treatment for investments that become qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company expects the adoption of this guidance to have no impact on its condensed consolidated financial statements.

In February 2016, the FASB issued updated guidance that requires the rights and obligations associated with leasing arrangements be reflected on the balance sheet in order to increase transparency and comparability among organizations. Under the updated guidance, lessees will be required to recognize a right-of-use asset and a liability to make lease payments and disclose key information about leasing arrangements. The updated guidance is effective for

interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In January 2016, the FASB issued updated guidance intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. In addition to making other targeted improvements to current guidance, the updated guidance also requires all equity investments, except those accounted for under the equity method of accounting or those that result in consolidation of the investee, to be measured at fair value with changes in the fair value recognized through net income. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted in certain circumstances. While the Company expects the adoption of this guidance to impact its condensed consolidated statements of income, the materiality of the impact will depend upon the size of, and level of volatility experienced within, the Company's equity portfolio.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

In May 2015, the FASB issued updated disclosure guidance related to short-duration contracts issued by insurance entities. The updated guidance is intended to increase the transparency of significant estimates made in measuring liabilities for unpaid claims and claim adjustment expenses and to provide additional insight into an insurance entity's ability to underwrite and anticipate costs associated with claims. The updated guidance is effective for annual reporting periods beginning after December 15, 2015 and for interim periods within annual periods beginning after December 15, 2016, with early adoption permitted. Except for the disclosure requirements, the Company does not expect the adoption of this guidance to impact its condensed consolidated financial statements.

In May 2014, the FASB issued updated guidance for recognizing revenue from contracts with customers to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within and across industries, and across capital markets. The new revenue standard contains principles that an entity will apply to determine the measurement of revenue and the timing of recognition. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. Revenue from insurance contracts is not within the scope of this guidance. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption prohibited. In August 2015, the FASB issued updated guidance which defers the effective date of this guidance by one year to interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted as of the original effective date. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

Note 2 – Escrow Deposits, Like-kind Exchange Deposits and Trust Assets

The Company administers escrow deposits and trust assets as a service to its customers. Escrow deposits totaled \$7.5 billion and \$6.6 billion at September 30, 2016 and December 31, 2015, respectively, of which \$3.1 billion and \$2.6 billion, respectively, were held at the Company's federal savings bank subsidiary, First American Trust, FSB. The escrow deposits held at First American Trust, FSB are temporarily invested in cash and cash equivalents and debt securities, with offsetting liabilities included in deposits in the accompanying condensed consolidated balance sheets. The remaining escrow deposits were held at third-party financial institutions.

Trust assets held or managed by First American Trust, FSB totaled \$3.2 billion and \$3.0 billion at September 30, 2016 and December 31, 2015, respectively. Escrow deposits held at third-party financial institutions and trust assets are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. However, the Company could be held contingently liable for the disposition of these assets.

In conducting its operations, the Company often holds customers' assets in escrow, pending completion of real estate transactions and, as a result, the Company has ongoing programs for realizing economic benefits with various financial institutions. The results from these programs are included in the condensed consolidated financial statements

as income or a reduction in expense, as appropriate, based on the nature of the arrangement and benefit received.

The Company facilitates tax-deferred property exchanges for customers pursuant to Section 1031 of the Internal Revenue Code and tax-deferred reverse exchanges pursuant to Revenue Procedure 2000-37. As a facilitator and intermediary, the Company holds the proceeds from sales transactions and takes temporary title to property identified by the customer to be acquired with such proceeds. Upon the completion of each such exchange, the identified property is transferred to the customer or, if the exchange does not take place, an amount equal to the sales proceeds or, in the case of a reverse exchange, title to the property held by the Company is transferred to the customer. Like-kind exchange funds held by the Company totaled \$2.2 billion and \$2.8 billion at September 30, 2016 and December 31, 2015, respectively. The like-kind exchange deposits are held at third-party financial institutions and, due to the structure utilized to facilitate these transactions, the proceeds and property are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. All such amounts are placed in deposit accounts insured, up to applicable limits, by the Federal Deposit Insurance Corporation. The Company could be held contingently liable to the customer for the transfers of property, disbursements of proceeds and the returns on such proceeds.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Note 3 – Debt and Equity Securities

Investments in debt securities, classified as available-for-sale, are as follows:

(in thousands)	Amortized cost	Gross unrealized Gains	Losses	Estimated fair value
September 30, 2016				
U.S. Treasury bonds	\$ 148,808	\$ 2,089	\$ (463 )	\$ 150,434
Municipal bonds	906,895	19,565	(2,223 )	924,237
Foreign government bonds	143,853	1,847	(342 )	145,358
Governmental agency bonds	192,430	2,870	(123 )	195,177
Governmental agency mortgage-backed securities	2,229,651	12,309	(6,163 )	2,235,797
U.S. corporate debt securities	674,651	17,722	(1,635 )	690,738
Foreign corporate debt securities	245,227	5,665	(463 )	250,429
	\$ 4,541,515	\$ 62,067	\$ (11,412 )	\$ 4,592,170
December 31, 2015				
U.S. Treasury bonds	\$ 130,252	\$ 421	\$ (1,301 )	\$ 129,372
Municipal bonds	692,000	12,640	(845 )	703,795
Foreign government bonds	129,984	1,132	(1,015 )	130,101
Governmental agency bonds	419,869	1,023	(2,801 )	418,091
Governmental agency mortgage-backed securities	2,065,728	4,984	(15,039 )	2,055,673
U.S. corporate debt securities	642,869	4,297	(12,483 )	634,683
Foreign corporate debt securities	210,162	1,248	(3,778 )	207,632
	\$ 4,290,864	\$ 25,745	\$ (37,262 )	\$ 4,279,347

Investments in equity securities, classified as available-for-sale, are as follows:

(in thousands)	Cost	Gross unrealized Gains	Losses	Estimated fair value
September 30, 2016				
Preferred stocks	\$ 19,311	\$ —	\$ (4,092 )	\$ 15,219
Common stocks	351,841	24,742	(3,881 )	372,702
	\$ 371,152	\$ 24,742	\$ (7,973 )	\$ 387,921
December 31, 2015				
Preferred stocks	\$ 18,305	\$ 420	\$ (3,258 )	\$ 15,467
Common stocks	307,429	13,103	(14,714 )	305,818
	\$ 325,734	\$ 13,523	\$ (17,972 )	\$ 321,285



Sales of debt and equity securities resulted in realized gains of \$8.9 million and \$1.3 million and realized losses of \$0.2 million and \$1.6 million for the three months ended September 30, 2016 and 2015, respectively, and realized gains of \$22.1 million and \$6.5 million and realized losses of \$7.2 million and \$8.2 million for the nine months ended September 30, 2016 and 2015, respectively.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Gross unrealized losses on investments in debt and equity securities are as follows:

(in thousands)	Less than 12 months Estimated fair value	Unrealized losses	12 months or longer Estimated fair value	Unrealized losses	Total Estimated fair value	Unrealized losses
September 30, 2016						
Debt securities:						
U.S. Treasury bonds	\$55,705	\$ (463 )	\$ —	\$ —	\$55,705	\$ (463 )
Municipal bonds	223,714	(1,941 )	16,401	(282 )	240,115	(2,223 )
Foreign government bonds	32,714	(313 )	363	(29 )	33,077	(342 )
Governmental agency bonds	5,706	(123 )	—	—	5,706	(123 )
Governmental agency mortgage-backed securities	749,900	(2,654 )	339,896	(3,509 )	1,089,796	(6,163 )
U.S. corporate debt securities	50,855	(634 )	30,740	(1,001 )	81,595	(1,635 )
Foreign corporate debt securities	21,121	(181 )	9,990	(282 )	31,111	(463 )
Total debt securities	1,139,715	(6,309 )	397,390	(5,103 )	1,537,105	(11,412 )
Equity securities	7,716	(74 )	76,717	(7,899 )	84,433	(7,973 )
Total	\$ 1,147,431	\$ (6,383 )	\$ 474,107	\$ (13,002 )	\$ 1,621,538	\$ (19,385 )
December 31, 2015						
Debt securities:						
U.S. Treasury bonds	\$ 105,701	\$ (1,285 )	\$ 1,654	\$ (16 )	\$ 107,355	\$ (1,301 )
Municipal bonds	133,465	(733 )	13,190	(112 )	146,655	(845 )
Foreign government bonds	13,601	(890 )	267	(125 )	13,868	(1,015 )
Governmental agency bonds	191,035	(2,497 )	18,237	(304 )	209,272	(2,801 )
Governmental agency mortgage-backed securities	1,096,301	(9,424 )	213,020	(5,615 )	1,309,321	(15,039 )
U.S. corporate debt securities	361,842	(11,272 )	13,511	(1,211 )	375,353	(12,483 )
Foreign corporate debt securities	102,801	(2,725 )	11,246	(1,053 )	114,047	(3,778 )
Total debt securities	2,004,746	(28,826 )	271,125	(8,436 )	2,275,871	(37,262 )
Equity securities	191,248	(12,068 )	31,974	(5,904 )	223,222	(17,972 )
Total	\$ 2,195,994	\$ (40,894 )	\$ 303,099	\$ (14,340 )	\$ 2,499,093	\$ (55,234 )

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Investments in debt securities at September 30, 2016, by contractual maturities, are as follows:

(in thousands)	Due in one year or less	Due after one through five years	Due after five through ten years	Due after ten years	Total
U.S. Treasury bonds					
Amortized cost	\$ 35,270	\$ 68,799	\$ 16,147	\$ 28,592	\$ 148,808
Estimated fair value	\$ 35,293	\$ 69,127	\$ 16,660	\$ 29,354	\$ 150,434
Municipal bonds					
Amortized cost	\$ 47,544	\$ 331,550	\$ 214,529	\$ 313,272	\$ 906,895
Estimated fair value	\$ 47,615	\$ 337,258	\$ 221,613	\$ 317,751	\$ 924,237
Foreign government bonds					
Amortized cost	\$ 4,447	\$ 107,304	\$ 11,240	\$ 20,862	\$ 143,853
Estimated fair value	\$ 4,482	\$ 108,323	\$ 11,702	\$ 20,851	\$ 145,358
Governmental agency bonds					
Amortized cost	\$ 20,771	\$ 82,989	\$ 47,203	\$ 41,467	\$ 192,430
Estimated fair value	\$ 20,781	\$ 83,238	\$ 47,561	\$ 43,597	\$ 195,177
U.S. corporate debt securities					
Amortized cost	\$ 15,513	\$ 318,116	\$ 274,598	\$ 66,424	\$ 674,651
Estimated fair value	\$ 15,578	\$ 324,386	\$ 281,216	\$ 69,558	\$ 690,738
Foreign corporate debt securities					
Amortized cost	\$ 9,521	\$ 114,704	\$ 110,180	\$ 10,822	\$ 245,227
Estimated fair value	\$ 9,532	\$ 116,436	\$ 112,776	\$ 11,685	\$ 250,429
Total debt securities excluding mortgage-backed securities					
Amortized cost	\$ 133,066	\$ 1,023,462	\$ 673,897	\$ 481,439	\$ 2,311,864
Estimated fair value	\$ 133,281	\$ 1,038,768	\$ 691,528	\$ 492,796	\$ 2,356,373
Total mortgage-backed securities					
Amortized cost					\$ 2,229,651
Estimated fair value					\$ 2,235,797
Total debt securities					
Amortized cost					\$ 4,541,515
Estimated fair value					\$ 4,592,170

Mortgage-backed securities, which include contractual terms to maturity, are not categorized by contractual maturity because borrowers may have the right to call or prepay obligations with, or without, call or prepayment penalties.



**FIRST AMERICAN FINANCIAL CORPORATION**
**AND SUBSIDIARY COMPANIES**
**Notes to Condensed Consolidated Financial Statements – (Continued)**

(unaudited)

The composition of the investment portfolio at September 30, 2016, by credit rating, is as follows:

	A- Ratings or higher		BBB+ to BBB-		Non-Investment Grade		Total	
	Estimated	Percentage	Estimated	Percentage	Estimated	Percentage	Estimated	Percentage
(in thousands, except percentages) fair value			fair value		fair value		fair value	
September 30, 2016								
Debt securities:								
U.S. Treasury bonds	\$ 150,434	100.0	\$—	—	\$—	—	\$ 150,434	100.0
Municipal bonds	879,726	95.2	35,861	3.8	8,650	1.0	924,237	100.0
Foreign government bonds	121,153	83.4	22,003	15.1	2,202	1.5	145,358	100.0
Governmental agency bonds	195,177	100.0	—	—	—	—	195,177	100.0
Governmental agency mortgage-backed securities	2,235,797	100.0	—	—	—	—	2,235,797	100.0
U.S. corporate debt securities	237,952	34.5	222,588	32.2	230,198	33.3	690,738	100.0
Foreign corporate debt securities	114,882	45.9	87,352	34.9	48,195	19.2	250,429	100.0
Total debt securities	3,935,121	85.7	367,804	8.0	289,245	6.3	4,592,170	100.0
Preferred stocks	—	—	8,987	59.1	6,232	40.9	15,219	100.0
Total	\$ 3,935,121	85.4	\$ 376,791	8.2	\$ 295,477	6.4	\$ 4,607,389	100.0

As of September 30, 2016, the estimated fair value of total debt securities included \$153.3 million of bank loans, of which \$141.8 million was non-investment grade; \$128.1 million of high yield corporate debt securities, all of which was non-investment grade; and \$68.8 million of emerging market debt securities, of which \$10.7 million was non-investment grade.

The composition of the investment portfolio in an unrealized loss position at September 30, 2016, by credit rating, is as follows:

	A- Ratings or higher		BBB+ to BBB-		Non-Investment Grade		Total	
	Estimated	Percentage	Estimated	Percentage	Estimated	Percentage	Estimated	Percentage
(in thousands, except percentages) fair value							fair value	

Edgar Filing: First American Financial Corp - Form 10-Q

			fair value		fair value			
September 30, 2016								
Debt securities:								
U.S. Treasury bonds	\$55,705	100.0	\$—	—	\$—	—	\$55,705	100.0
Municipal bonds	233,406	97.2	5,332	2.2	1,377	0.6	240,115	100.0
Foreign government bonds	19,904	60.1	12,197	36.9	976	3.0	33,077	100.0
Governmental agency bonds	5,706	100.0	—	—	—	—	5,706	100.0
Governmental agency mortgage-backed securities	1,089,796	100.0	—	—	—	—	1,089,796	100.0
U.S. corporate debt securities	7,342	9.0	29,664	36.4	44,589	54.6	81,595	100.0
Foreign corporate debt securities	3,004	9.7	15,461	49.7	12,646	40.6	31,111	100.0
Total debt securities	1,414,863	92.0	62,654	4.1	59,588	3.9	1,537,105	100.0
Preferred stocks	—	—	8,987	59.1	6,232	40.9	15,219	100.0
Total	\$1,414,863	91.2	\$71,641	4.6	\$65,820	4.2	\$1,552,324	100.0

As of September 30, 2016, the estimated fair value of total debt securities in an unrealized loss position included \$18.1 million of bank loans, of which \$18.0 million was non-investment grade; \$36.3 million of high yield corporate debt securities, all of which was non-investment grade; and \$17.6 million of emerging market debt securities, of which \$3.9 million was non-investment grade.

The credit ratings in the above tables reflect published ratings obtained from Standard & Poor's Rating Services, DBRS, Inc., Fitch Ratings, Inc. and Moody's Investor Services, Inc. If a security was rated differently among the rating agencies, the lowest rating was selected. Governmental agency mortgage-backed securities are not rated by any of the ratings agencies; however, these securities have been included in the above table in the A- Ratings or higher category because the payments of principal and interest are guaranteed by the governmental agency that issued the security.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

## Note 4 – Goodwill

A summary of the changes in the carrying amount of goodwill, by operating segment, for the nine months ended September 30, 2016, is as follows:

(in thousands)	Title Insurance and Services	Specialty Insurance	Total
Balance as of December 31, 2015	\$ 917,577	\$ 46,765	\$964,342
Acquisitions	49,570	—	49,570
Foreign currency translation	1,146	—	1,146
Other adjustments	(294 )	—	(294 )
Balance as of September 30, 2016	\$ 967,999	\$ 46,765	\$ 1,014,764

The Company's four reporting units for purposes of assessing impairment are title insurance, home warranty, property and casualty insurance and trust and other services. During the nine months ended September 30, 2016 there were no triggering events that would require an impairment analysis. There is no accumulated impairment for goodwill as the Company has never recognized impairment to any of its reporting units.

## Note 5 – Other Intangible Assets

Other intangible assets consist of the following:

(in thousands)	September 30, 2016	December 31, 2015
Finite-lived intangible assets:		
Customer relationships	\$95,777	\$ 93,572
Noncompete agreements	28,174	26,963

Edgar Filing: First American Financial Corp - Form 10-Q

Trademarks	8,621	9,341
Internal-use software licenses	11,006	—
Patents	2,840	2,840
	146,418	132,716
Accumulated amortization	(111,898)	(101,479 )
	34,520	31,237
Indefinite-lived intangible assets:		
Licenses	16,897	16,877
	\$51,417	\$ 48,114

Amortization expense for finite-lived intangible assets was \$3.7 million and \$9.3 million for the three and nine months ended September 30, 2016, respectively, and \$2.3 million and \$7.1 million for the three and nine months ended September 30, 2015, respectively.

Estimated amortization expense for finite-lived intangible assets for the next five years is as follows:

Year	(in thousands)
Remainder of 2016	\$ 4,490
2017	\$ 11,163
2018	\$ 6,763
2019	\$ 4,401
2020	\$ 2,278
2021	\$ 1,151



## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

## Note 6 – Reserve for Known and Incurred But Not Reported Claims

A summary of the Company's loss reserves is as follows:

(in thousands, except percentages)	September 30, 2016			December 31, 2015		
Known title claims	\$ 74,206	7.3	%	\$ 87,543	8.9	%
Incurred but not reported claims	886,643	87.1	%	844,364	85.8	%
Total title claims	960,849	94.4	%	931,907	94.7	%
Non-title claims	57,191	5.6	%	51,973	5.3	%
Total loss reserves	\$ 1,018,040	100.0	%	\$ 983,880	100.0	%

The provision for title insurance losses, expressed as a percentage of title insurance premiums and escrow fees, was 5.5% for the three and nine months ended September 30, 2016 compared to 6.6% for the three and nine months ended September 30, 2015. The current quarter rate of 5.5% reflects the ultimate loss rate of 5.0% for the current policy year and a \$5.8 million net increase in the loss reserve estimates for prior policy years. The third quarter of 2015 rate of 6.6% reflected the ultimate loss rate of 6.0% for the 2015 policy year and a \$6.2 million net increase in the loss reserve estimates for prior policy years.

## Note 7 – Notes and Contracts Payable

In September 2016, the Company borrowed \$160.0 million under its credit facility to fund acquisitions and to partially fund its obligation in connection with the termination of its pension plan. As a result, the Company's available borrowing capacity under its credit facility was reduced from \$700.0 million to \$540.0 million. At September 30, 2016, outstanding borrowings under the facility totaled \$160.0 million at an interest rate of 2.28%. See Note 10 Employee Benefit Plans for further discussion of the Company's pension termination and Note 15 Business Combinations for further discussion of the Company's acquisitions.

## Note 8 – Income Taxes

The Company's effective income tax rates (income tax expense as a percentage of income before income taxes) were 35.7% and 33.7% for the three and nine months ended September 30, 2016, respectively, and 34.3% and 34.4% for the three and nine months ended September 30, 2015, respectively. The effective tax rates differ from the statutory

federal rate of 35% primarily due to changes in state and foreign income taxes resulting from fluctuations in the Company's noninsurance and foreign subsidiaries' contribution to pretax income and changes in the ratio of permanent differences to income before income taxes. The rates for both the three and nine months ended September 30, 2016 reflect the resolution of certain tax authority examinations and tax credits claimed in current and prior years.

In connection with the Company's June 2010 spin-off from its prior parent, which subsequently assumed the name CoreLogic, Inc. ("CoreLogic"), it entered into a tax sharing agreement which governs the Company's and CoreLogic's respective rights, responsibilities and obligations for certain tax-related matters. At September 30, 2016 and December 31, 2015, the Company had a net payable to CoreLogic of \$37.5 million and \$36.5 million, respectively, related to tax matters prior to the spin-off. This amount is included in the Company's condensed consolidated balance sheets in accounts payable and accrued liabilities. The increase during the current year was primarily the result of an additional accrual for tax matters prior to the spin-off.

The Company evaluates the realizability of its deferred tax assets by assessing the valuation allowance and adjusts the allowance, if necessary. The factors used to assess the likelihood of realization are the Company's forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. The ability or failure to achieve the forecasted taxable income in the applicable taxing jurisdictions could affect the ultimate realization of deferred tax assets. Based on future operating results in certain jurisdictions, it is possible that the current valuation allowance positions of those jurisdictions could be adjusted in the next 12 months.

# FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

### Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

As of September 30, 2016 and December 31, 2015, the liability for income taxes associated with uncertain tax positions was \$26.8 million and \$23.8 million, respectively. The net increase in the liability during 2016 was primarily attributable to reserves for tax positions taken by the Company. As of September 30, 2016 and December 31, 2015, the liabilities could be reduced by \$3.6 million and \$3.4 million, respectively, of offsetting tax benefits associated with the correlative effects of potential adjustments, including timing adjustments and state income taxes. The net amounts of \$23.2 million and \$20.4 million as of September 30, 2016 and December 31, 2015, respectively, if recognized, would favorably affect the Company's effective tax rate.

The Company's continuing practice is to recognize interest and penalties, if any, related to uncertain tax positions in income tax expense. As of September 30, 2016 and December 31, 2015, the Company had accrued \$9.5 million and \$9.7 million, respectively, of interest and penalties (net of tax benefits of \$4.4 million and \$4.1 million, respectively) related to uncertain tax positions.

It is reasonably possible that the amount of the unrecognized benefit with respect to certain of the Company's unrecognized tax positions may significantly decrease within the next 12 months. This change may be the result of ongoing audits or the expiration of federal and state statutes of limitations for the assessment of taxes.

The Company, or one of its subsidiaries, files income tax returns in the U.S. federal jurisdiction, various state jurisdictions, and various non-U.S. jurisdictions. The primary non-federal jurisdictions are California, Canada, India and the United Kingdom. The Company is generally no longer subject to U.S. federal, state and non-U.S. income tax examinations by taxing authorities for years prior to 2005.

### Note 9 – Earnings Per Share

The computation of basic and diluted earnings per share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands, except per share amounts)	2016	2015	2016	2015
Numerator				
Net income attributable to the Company	\$ 107,320	\$ 75,542	\$ 261,970	\$ 206,520
Less: dividends and undistributed earnings allocated to unvested restricted stock units ("RSUs")	—	68	—	230
Net income allocated to common stockholders	\$ 107,320	\$ 75,474	\$ 261,970	\$ 206,290

Edgar Filing: First American Financial Corp - Form 10-Q

Denominator				
Basic weighted-average shares	110,571	108,647	110,423	108,284
Effect of dilutive employee stock options and RSUs	680	1,357	583	1,422
Diluted weighted-average shares	111,251	110,004	111,006	109,706
Net income per share attributable to the Company's stockholders				
Basic	\$0.97	\$0.69	\$2.37	\$1.91
Diluted	\$0.96	\$0.69	\$2.36	\$1.88

For the three months ended September 30, 2016, no stock options or RSUs had an antidilutive effect on weighted-average diluted common shares outstanding. For the nine months ended September 30, 2016, 17 thousand RSUs were excluded from weighted-average diluted common shares outstanding due to their antidilutive effect. For the three and nine months ended September 30, 2015, 2 thousand RSUs and 1 thousand RSUs, respectively, were excluded from weighted-average diluted common shares outstanding due to their antidilutive effect.

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

## Note 10 – Employee Benefit Plans

Net periodic cost related to the Company's funded defined benefit pension and unfunded supplemental benefit plans includes the following components:

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Expense:				
Service costs	\$ 260	\$ 390	\$ 781	\$ 1,170
Interest costs	5,999	6,786	18,000	20,805
Expected return on plan assets	(3,083 )	(5,341 )	(9,250 )	(16,237 )
Amortization of net actuarial loss	7,043	7,613	21,153	24,596
Amortization of prior service credit	(1,211 )	(1,041 )	(3,633 )	(3,122 )
	\$ 9,008	\$ 8,407	\$ 27,051	\$ 27,212

## Pension termination and settlement

In May 2016, the Company's board of directors terminated the Company's funded defined benefit pension plan known as the First American Financial Corporation Pension Plan (the "Pension Plan") effective as of July 31, 2016. The Pension Plan was closed to new entrants effective December 31, 2001 and amended to "freeze" all benefit accruals as of April 30, 2008. Also, in May 2016, a subsidiary of the Company terminated its small regional funded defined benefit pension plan effective as of August 31, 2016. The Company expects the termination of both pension plans to occur over a similar timeframe. Upon completion of these terminations, the Company will have no remaining funded defined benefit pension plan obligations. All financial impacts discussed below reflect the termination of both pension plans.

The Pension Plan offers participants annuity payments based on a number of factors. The Pension Plan will also offer an alternative lump sum distribution to certain participants. After certain regulatory approvals are obtained, the Company will provide additional cash contributions to the Pension Plan to ensure that sufficient assets are available to make lump sum distribution payments, purchase group annuity contracts from one or more highly rated insurance companies to pay and administer future benefit payments, and complete other transactions required to terminate the Pension Plan in a manner that fully meets its obligations to all participants. The total amount of additional cash contributions required to be provided by the Company will depend upon changes in interest rates, Pension Plan asset returns, the lump sum election rate, and other factors. To sufficiently fund the Pension Plan, the Company contributed an additional cash contribution of \$55.9 million in September 2016 and expects to make an additional cash contribution of approximately \$44 million. The Company also expects to pay other termination related expenses.

As of December 31, 2015, the Company reported net unrealized losses of \$197 million, before tax, in accumulated other comprehensive loss on its consolidated balance sheet related to the Pension Plan. These net unrealized losses, as

well as other expenses estimated to be approximately \$15 million, before tax, will be recognized in the Company's consolidated statement of income in two separate quarters as payments are made, initially to settle lump sum elections, and later to purchase group annuity contracts. The Company expects to make distributions to participants electing lump sum payouts and to recognize approximately \$81 million in net unrealized losses during the fourth quarter of 2016. The Company expects to complete the transfer of all remaining liabilities and administrative responsibilities related to the Pension Plan to one or more highly rated insurance companies and to recognize approximately \$131 million in net unrealized losses and other expenses by the end of the third quarter of 2017. The preceding information related to the expected amounts and timing of pension termination expenses to be recognized are estimates based on net unrealized losses as of December 31, 2015 and actual amounts recognized may differ due to changes in interest rates, Pension Plan asset returns, the lump sum election rate, and other factors.

Certain aspects of the transactions required to terminate the Pension Plan and settle its obligations are subject to regulatory review.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Note 11 – Fair Value Measurements

Certain of the Company's assets are carried at fair value. Fair value is defined as 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.

The Company categorizes its assets and liabilities carried at fair value using a three-level hierarchy for fair value measurements that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the Company (observable inputs) and the Company's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The hierarchy for inputs used in determining fair value maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. The hierarchy level assigned to the assets and liabilities is based on management's assessment of the transparency and reliability of the inputs used to estimate the fair values at the measurement date. The three hierarchy levels are defined as follows:

Level 1—Valuations based on unadjusted quoted market prices in active markets for identical assets or liabilities.

Level 2—Valuations based on observable inputs (other than Level 1 prices), such as quoted prices for similar assets or liabilities at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly.

Level 3—Valuations based on inputs that are unobservable and significant to the overall fair value measurement, and involve management judgment.

If the inputs used to measure fair value fall into different levels of the fair value hierarchy, the hierarchy level assigned is based upon the lowest level of input that is significant to the fair value measurement.

Assets measured at fair value on a recurring basis

The valuation techniques and inputs used by the Company to estimate the fair value of assets measured on a recurring basis are summarized as follows:

Debt securities

The fair values of debt securities were based on the market values obtained from independent pricing services that were evaluated using pricing models that vary by asset class and incorporate available trade, bid and other market information and price quotes from well-established independent broker-dealers. The independent pricing services monitor market indicators, industry and economic events, and for broker-quoted only securities, obtain quotes from market makers or broker-dealers that they recognize to be market participants. The pricing services utilize the market approach in determining the fair value of the debt securities held by the Company. The Company obtains an understanding of the valuation models and assumptions utilized by the services and has controls in place to determine

that the values provided represent fair value. The Company's validation procedures include comparing prices received from the pricing services to quotes received from other third party sources for certain securities with market prices that are readily verifiable. If the price comparison results in differences over a predefined threshold, the Company will assess the reasonableness of the changes relative to prior periods given the prevailing market conditions and assess changes in the issuers' credit worthiness, performance of any underlying collateral and prices of the instrument relative to similar issuances. To date, the Company has not made any material adjustments to the fair value measurements provided by the pricing services.

Typical inputs and assumptions to pricing models used to value the Company's U.S. Treasury bonds, municipal bonds, foreign government bonds, governmental agency bonds, governmental agency mortgage-backed securities and U.S. and foreign corporate debt securities include, but are not limited to, benchmark yields, reported trades, broker-dealer quotes, credit spreads, credit ratings, bond insurance (if applicable), benchmark securities, bids, offers, reference data and industry and economic events. For mortgage-backed securities, inputs and assumptions may also include the structure of issuance, characteristics of the issuer, collateral attributes and prepayment speeds. Non-agency mortgage-backed securities and certain corporate debt securities were not actively traded and there were fewer observable inputs available requiring the use of more judgment in determining their fair values, which resulted in their classification as Level 3.



## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

## Equity securities

The fair values of equity securities, including preferred and common stocks, were based on quoted market prices for identical assets that are readily and regularly available in an active market.

The following tables present the fair values of the Company's assets, measured on a recurring basis, as of September 30, 2016 and December 31, 2015:

(in thousands)	Total	Level 1	Level 2	Level 3
September 30, 2016				
Assets:				
Debt securities:				
U.S. Treasury bonds	\$ 150,434	\$ —	\$ 150,434	\$ —
Municipal bonds	924,237	—	924,237	—
Foreign government bonds	145,358	—	145,358	—
Governmental agency bonds	195,177	—	195,177	—
Governmental agency mortgage-backed securities	2,235,797	—	2,235,797	—
U.S. corporate debt securities	690,738	—	673,239	17,499
Foreign corporate debt securities	250,429	—	248,668	1,761
	4,592,170	—	4,572,910	19,260
Equity securities:				
Preferred stocks	15,219	15,219	—	—
Common stocks	372,702	372,702	—	—
	387,921	387,921	—	—
Total assets	\$4,980,091	\$387,921	\$4,572,910	\$19,260

(in thousands)	Total	Level 1	Level 2	Level 3
December 31, 2015				
Assets:				
Debt securities:				
U.S. Treasury bonds	\$ 129,372	\$ —	\$ 129,372	\$ —
Municipal bonds	703,795	—	703,795	—
Foreign government bonds	130,101	—	130,101	—
Governmental agency bonds	418,091	—	418,091	—
Governmental agency mortgage-backed securities	2,055,673	—	2,055,673	—
U.S. corporate debt securities	634,683	—	591,116	43,567

Edgar Filing: First American Financial Corp - Form 10-Q

Foreign corporate debt securities	207,632	—	201,060	6,572
	4,279,347	—	4,229,208	50,139
Equity securities:				
Preferred stocks	15,467	15,467	—	—
Common stocks	305,818	305,818	—	—
	321,285	321,285	—	—
Total assets	\$4,600,632	\$321,285	\$4,229,208	\$50,139

There were no transfers between Levels 1 and 2 during the three and nine months ended September 30, 2016 and 2015. Transfers into or out of the Level 3 category occur when unobservable inputs become more or less significant to the fair value measurement. For the three and nine months ended September 30, 2016, and for the three months ended September 30, 2015, transfers between Level 2 and Level 3 were based on market liquidity and related transparency of pricing and associated observable inputs for certain of the Company's corporate debt securities. There were no transfers in or out of Level 3 during the nine months ended September 30, 2015. The Company's policy is to recognize transfers between levels in the fair value hierarchy at the end of the reporting period.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

The following table presents a summary of the changes in the fair values of Level 3 assets, measured on a recurring basis, for the three months ended September 30, 2016 and 2015:

(in thousands)	September 30, 2016			September 30, 2015		
	U.S. corporate debt	Foreign corporate debt	Total	U.S. corporate debt	Foreign corporate debt	Total
Fair value at beginning of period	\$14,493	\$ 723	\$15,216	\$9,314	\$ 2,044	\$11,358
Transfers into Level 3	5,968	—	5,968	1,899	22	1,921
Transfers out of Level 3	(4,546 )	—	(4,546 )	(2,634 )	(1,377 )	(4,011 )
Net realized and unrealized gains (losses):						
Included in earnings	5	—	5	(2 )	—	(2 )
Included in other comprehensive income (loss)	115	43	158	(31 )	(9 )	(40 )
Purchases	1,866	1,045	2,911	1,694	4	1,698
Sales	(46 )	(50 )	(96 )	(92 )	—	(92 )
Settlements	(356 )	—	(356 )	(2,312 )	(162 )	(2,474 )
Fair value at end of period	\$17,499	\$ 1,761	\$19,260	\$7,836	\$ 522	\$8,358
Unrealized gains (losses) included in earnings for the period relating to Level 3 assets that were still held at the end of the period:						
Net realized investment gains (losses)	\$—	\$ —	\$—	\$—	\$ —	\$—

The following table presents a summary of the changes in the fair values of Level 3 assets, measured on a recurring basis, for the nine months ended September 30, 2016 and 2015:

(in thousands)	September 30, 2016			September 30, 2015			
	U.S. corporate debt	Foreign corporate debt	Total	U.S. corporate debt	Foreign corporate debt	Non-agency mortgage- backed securities	Total

Edgar Filing: First American Financial Corp - Form 10-Q

	securities			securities			
Fair value at beginning of period	\$43,567	\$ 6,572	\$50,139	\$—	\$ —	\$ 16,538	\$16,538
Transfers into Level 3	269	—	269	—	—	—	—
Transfers out of Level 3	(27,764)	(3,822 )	(31,586)	—	—	—	—
Net realized and unrealized gains (losses):							
Included in earnings	(88 )	(48 )	(136 )	1	—	(1,015 )	(1,014 )
Included in other comprehensive income (loss)	1,053	88	1,141	—	6	(589 )	(583 )
Purchases	10,132	1,243	11,375	8,316	515	—	8,831
Sales	(4,750 )	(1,045 )	(5,795 )	(427 )	—	(14,934 )	(15,361)
Settlements	(4,920 )	(1,227 )	(6,147 )	(54 )	1	—	(53 )
Fair value at end of period	\$17,499	\$ 1,761	\$19,260	\$7,836	\$ 522	\$—	\$8,358
Unrealized gains (losses) included in earnings for the period relating to Level 3 assets that were still held at the end of the period:							
Net realized investment gains (losses)	\$ (5 )	\$ —	\$ (5 )	\$ —	\$ —	\$ —	\$ —
Financial instruments not measured at fair value							

In estimating the fair values of its financial instruments not measured at fair value, the Company used the following methods and assumptions:

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Cash and cash equivalents

The carrying amount for cash and cash equivalents is a reasonable estimate of fair value due to the short-term maturity of these investments.

Deposits with banks

The fair value of deposits with banks is estimated based on rates currently offered for deposits of similar remaining maturities, where applicable.

Notes receivable, net

The fair value of notes receivable, net is estimated based on current market rates being offered for notes with similar maturities and credit quality.

Deposits

The carrying value of escrow and other deposit accounts approximates fair value due to the short-term nature of these liabilities.

Notes and contracts payable

The fair value of notes and contracts payable is estimated based on current rates offered to the Company for debt of similar remaining maturities.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments not measured at fair value as of September 30, 2016 and December 31, 2015:

(in thousands)	Carrying Amount	Estimated fair value Total	Level 1	Level 2	Level 3
<b>September 30, 2016</b>					
<b>Assets:</b>					
Cash and cash equivalents	\$1,443,312	\$1,443,312	\$1,443,312	\$—	\$—
Deposits with banks	\$22,257	\$22,214	\$1,110	\$21,104	\$—
Notes receivable, net	\$7,007	\$6,893	\$—	\$—	\$6,893
<b>Liabilities:</b>					
Deposits	\$3,218,128	\$3,218,128	\$3,218,128	\$—	\$—
Notes and contracts payable	\$737,944	\$763,860	\$—	\$758,073	\$5,787

Edgar Filing: First American Financial Corp - Form 10-Q

(in thousands)	Carrying Amount	Estimated fair value Total	Level 1	Level 2	Level 3
December 31, 2015					
Assets:					
Cash and cash equivalents	\$1,027,321	\$1,027,321	\$1,027,321	\$—	\$—
Deposits with banks	\$23,224	\$23,211	\$1,103	\$22,108	\$—
Notes receivable, net	\$5,866	\$5,791	\$—	\$—	\$5,791
Liabilities:					
Deposits	\$2,699,015	\$2,699,015	\$2,699,015	\$—	\$—
Notes and contracts payable	\$581,052	\$590,970	\$—	\$583,893	\$7,077

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Note 12 – Share-Based Compensation

The following table presents compensation expense associated with the Company's share-based compensation plans:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Expense:				
RSUs	\$ 5,401	\$ 4,059	\$25,766	\$18,278
Stock options	68	68	203	203
Employee stock purchase plan	659	571	2,127	1,780
	\$ 6,128	\$ 4,698	\$28,096	\$20,261

The following table summarizes RSU activity for the nine months ended September 30, 2016:

(in thousands, except weighted-average grant-date fair value)	Weighted-average grant-date	
	Shares	fair value
RSUs unvested at December 31, 2015	1,354	\$ 29.20
Granted during 2016	967	36.77
Vested during 2016	(726 )	30.76
Forfeited during 2016	(20 )	31.48
RSUs unvested at September 30, 2016	1,575	\$ 33.10

The following table summarizes stock option activity for the nine months ended September 30, 2016:

(in thousands, except weighted-average exercise price and contractual term)	Number outstanding	Weighted- average exercise price	Weighted- average remaining	Aggregate intrinsic value

			contractual term	
Balance at December 31, 2015	132	\$ 27.66		
Exercised during 2016	—	—		
Balance at September 30, 2016	132	\$ 27.66	7.2 years	\$ 1,391
Vested and expected to vest at September 30, 2016	132	\$ 27.66	7.2 years	\$ 1,391
Exercisable at September 30, 2016	66	\$ 27.66	7.2 years	\$ 696



## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

## Note 13 – Accumulated Other Comprehensive Income (Loss) (“AOCI”)

The following table presents a summary of the changes in each component of AOCI for the nine months ended September 30, 2016:

	Unrealized	Foreign	Pension	Accumulated
	gains (losses)	currency	benefit	other
	on securities	translation	adjustment	comprehensive
(in thousands)	on securities	adjustment	adjustment	income (loss)
Balance at December 31, 2015	\$ (16,401 )	\$ (57,242 )	\$ (165,357 )	\$ (239,000 )
Change in unrealized gains (losses) on securities	83,390	—	—	83,390
Change in foreign currency translation adjustment	—	3,066	—	3,066
Amortization of net actuarial loss	—	—	21,153	21,153
Amortization of prior service cost	—	—	(3,633 )	(3,633 )
Tax effect	(31,303 )	—	(6,701 )	(38,004 )
Balance at September 30, 2016	\$ 35,686	\$ (54,176 )	\$ (154,538 )	\$ (173,028 )
Allocated to the Company	\$ 35,662	\$ (54,176 )	\$ (154,538 )	\$ (173,052 )
Allocated to noncontrolling interests	24	—	—	24
Balance at September 30, 2016	\$ 35,686	\$ (54,176 )	\$ (154,538 )	\$ (173,028 )

The following table presents the other comprehensive income (loss) reclassification adjustments for the three months ended September 30, 2016 and 2015:

	Unrealized	Foreign	Pension	Total
	gains (losses)	currency	benefit	other
	on securities	translation	adjustment	comprehensive
(in thousands)	on securities	adjustment	adjustment	income (loss)

Edgar Filing: First American Financial Corp - Form 10-Q

Three Months Ended September 30, 2016				
Pretax change before reclassifications	\$ 12,435	\$ (3,459 )	\$ —	\$ 8,976
Reclassifications out of AOCI	(8,687 )	—	5,832	(2,855 )
Tax effect	(1,169 )	—	(2,230 )	(3,399 )
Total other comprehensive income (loss), net of tax	\$ 2,579	\$ (3,459 )	\$ 3,602	\$ 2,722
Three Months Ended September 30, 2015				
Pretax change before reclassifications	\$ (15,614 )	\$ (15,416 )	\$ —	\$ (31,030 )
Reclassifications out of AOCI	(108 )	—	6,572	6,464
Tax effect	4,780	—	(2,514 )	2,266
Total other comprehensive income (loss), net of tax	\$ (10,942 )	\$ (15,416 )	\$ 4,058	\$ (22,300 )

## FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

## Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

The following table presents the other comprehensive income (loss) reclassification adjustments for the nine months ended September 30, 2016 and 2015:

	Unrealized	Foreign	Pension	Total
	gains (losses)	currency	benefit	other
	on securities	translation	adjustment	comprehensive
(in thousands)		adjustment	adjustment	income (loss)
<b>Nine Months Ended September 30, 2016</b>				
Pretax change before reclassifications	\$ 96,612	\$ 3,066	\$ —	\$ 99,678
Reclassifications out of AOCI	(13,222 )	—	17,520	4,298
Tax effect	(31,303 )	—	(6,701 )	(38,004 )
Total other comprehensive income (loss), net of tax	\$ 52,087	\$ 3,066	\$ 10,819	\$ 65,972
<b>Nine Months Ended September 30, 2015</b>				
Pretax change before reclassifications	\$ (29,966 )	\$ (29,210 )	\$ —	\$ (59,176 )
Reclassifications out of AOCI	1,545	—	21,474	23,019
Tax effect	9,047	—	(8,214 )	833
Total other comprehensive income (loss), net of tax	\$ (19,374 )	\$ (29,210 )	\$ 13,260	\$ (35,324 )

The following table presents the effect of the reclassifications out of AOCI on the respective line items in the condensed consolidated statements of income:

	Amounts reclassified from AOCI				
	Three Months		Nine Months		
	Ended		Ended		
(in thousands)	September 30,	September 30,	September 30,	September 30,	Affected line items in the condensed
	2016	2015	2016	2015	consolidated statements of income
Unrealized gains					
(losses) on securities:					
Net realized gains					
(losses) on sales of					
securities	\$8,687	\$108	\$13,707	\$(1,545 )	Net realized investment gains (losses)
Net					
other-than-temporary					
impairment losses	—	—	(485 )	—	Net realized investment gains (losses)

Edgar Filing: First American Financial Corp - Form 10-Q

Pretax total	\$8,687	\$108	\$13,222	\$(1,545 )
Tax effect	\$(3,261)	\$(33 )	\$(5,057 )	\$492
Pension benefit adjustment:				
Amortization of employee benefit plan items:				
Net actuarial loss	\$(7,043)	\$(7,613)	\$(21,153)	\$(24,596)(1)
Prior service credit	1,211	1,041	3,633	3,122 (1)
Pretax total	\$(5,832)	\$(6,572)	\$(17,520)	\$(21,474)
Tax effect	\$2,229	\$2,514	\$6,701	\$8,214

(1) These components of AOCI are included in the computation of net periodic cost. See Note 10 Employee Benefit Plans for additional details.

FIRST AMERICAN FINANCIAL CORPORATION  
AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Note 14 – Litigation and Regulatory Contingencies

The Company and its subsidiaries are parties to a number of non-ordinary course lawsuits. These lawsuits frequently are similar in nature to other lawsuits pending against the Company's competitors.

For those non-ordinary course lawsuits where the Company has determined that a loss is both probable and reasonably estimable, a liability representing the best estimate of the Company's financial exposure based on known facts has been recorded. Actual losses may materially differ from the amounts recorded.

For a substantial majority of these lawsuits, however, it is not possible to assess the probability of loss. Most of these lawsuits are putative class actions which require a plaintiff to satisfy a number of procedural requirements before proceeding to trial. These requirements include, among others, demonstration to a court that the law proscribes in some manner the Company's activities, the making of factual allegations sufficient to suggest that the Company's activities exceeded the limits of the law and a determination by the court—known as class certification—that the law permits a group of individuals to pursue the case together as a class. In certain instances the Company may also be able to compel the plaintiff to arbitrate its claim on an individual basis. If these procedural requirements are not met, either the lawsuit cannot proceed or, as is the case with class certification or compelled arbitration, the plaintiffs lose the financial incentive to proceed with the case (or the amount at issue effectively becomes de minimis). Frequently, a court's determination as to these procedural requirements is subject to appeal to a higher court. As a result of, among other factors, ambiguities and inconsistencies in the myriad laws applicable to the Company's business and the uniqueness of the factual issues presented in any given lawsuit, the Company often cannot determine the probability of loss until a court has finally determined that a plaintiff has satisfied applicable procedural requirements.

Furthermore, because most of these lawsuits are putative class actions, it is often impossible to estimate the possible loss or a range of loss amounts, even where the Company has determined that a loss is reasonably possible. Generally class actions involve a large number of people and the effort to determine which people satisfy the requirements to become plaintiffs—or class members—is often time consuming and burdensome. Moreover, these lawsuits raise complex factual issues which result in uncertainty as to their outcome and, ultimately, make it difficult for the Company to estimate the amount of damages which a plaintiff might successfully prove. In addition, many of the Company's businesses are regulated by various federal, state, local and foreign governmental agencies and are subject to numerous statutory guidelines. These regulations and statutory guidelines often are complex, inconsistent or ambiguous, which results in additional uncertainty as to the outcome of a given lawsuit—including the amount of damages a plaintiff might be afforded—or makes it difficult to analogize experience in one case or jurisdiction to another case or jurisdiction.

Most of the non-ordinary course lawsuits to which the Company and its subsidiaries are parties challenge practices in the Company's title insurance business, though a limited number of cases also pertain to the Company's other businesses. These lawsuits include, among others, cases alleging, among other assertions, that the Company, one of its subsidiaries and/or one of its agents:

- charged an improper rate for title insurance in a refinance transaction, including

¶ Lewis v. First American Title Insurance Company, filed on November 28, 2006 and pending in the United States District Court for the District of Idaho.

A court has granted class certification in Lewis. For the reasons stated above, the Company has been unable to assess the probability of loss or estimate the possible loss or the range of loss.

- purchased minority interests in title insurance agents as an inducement to refer title insurance underwriting business to the Company or gave items of value to title insurance agents and others for referrals of business in violation of the Real Estate Settlement Procedures Act, including

¶ Edwards v. First American Financial Corporation, filed on June 12, 2007 and pending in the United States District Court for the Central District of California.

In Edwards the court has issued final approval of a settlement. The anticipated loss, for which a liability has been previously recorded, is not material to the condensed consolidated financial statements as a whole.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

• misclassified certain employees, including

• Cruz v. First American Financial Corporation, et al., filed on November 25, 2015 and pending in the Superior Court of the State of California, County of Orange,

• Sager v. Interthinx, Inc., filed on January 23, 2015 and pending in the Superior Court of the State of California, County of Los Angeles, and

• Weber v. Interthinx, Inc., et al., filed on April 17, 2015 and pending in the United States District Court for the Eastern District of Missouri.

These lawsuits are putative class actions for which a class has not been certified. For the reasons described above, as well as the applicability of certain indemnification rights the Company may have, the Company has not yet been able to assess the probability of loss or estimate the possible loss or the range of loss or, where the Company has been able to make an estimate, the Company believes the amount is not material to the condensed consolidated financial statements as a whole.

• overcharged or improperly charged fees for products and services, conspired to fix prices, participated in the conveyance of illusory property interests, denied home warranty claims, and gave items of value to builders, brokers and others as inducements to refer business in violation of certain laws, such as consumer protection laws and laws generally prohibiting unfair business practices, and certain obligations, including

• Chassen v. First American Financial Corporation, et al., filed on January 22, 2009 and pending in the United States District Court of New Jersey,

• Downing v. First American Title Insurance Company, et al., filed on July 26, 2016 and pending in the Northern District of Georgia,

• Kaufman v. First American Financial Corporation, et al., filed on December 21, 2007 and pending in the Superior Court of the State of California, County of Los Angeles,

• Kirk v. First American Financial Corporation, et al., filed on June 15, 2006 and pending in the Superior Court of the State of California, County of Los Angeles,

• Lennen v. First American Financial Corporation, et al., filed on May 19, 2016 and pending in the United States District court for the Middle District of Florida,

• McCormick v. First American Real Estate Services, Inc., et al., filed on December 31, 2015 and pending in the Superior Court of the State of California, County of Orange,

• Sjobring v. First American Financial Corporation, et al., filed on February 25, 2005 and pending in the Superior Court of the State of California, County of Los Angeles,

• Wilmot v. First American Financial Corporation, et al., filed on April 20, 2007 and pending in the Superior Court of the State of California, County of Los Angeles, and

• In re First American Home Buyers Protection Corporation, consolidated on October 9, 2014 and pending in the United States District Court for the Southern District of California.

All of these lawsuits, except Kaufman and Kirk, are putative class actions for which a class has not been certified. In Kaufman a class was certified but that certification was subsequently vacated. A trial of the Kirk matter has concluded and the judgment has been affirmed on appeal. For the reasons described above, the Company has not yet been able to assess the probability of loss or estimate the possible loss or the range of loss or, where the Company has been able to make an estimate, the Company believes the amount is not material to the condensed consolidated financial statements as a whole.

While some of the lawsuits described above may be material to the Company's operating results in any particular period if an unfavorable outcome results, the Company does not believe that any of these lawsuits will have a material adverse effect on the Company's overall financial condition or liquidity.



FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

The Company also is a party to non-ordinary course lawsuits other than those described above. With respect to these lawsuits, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.

The Company's title insurance, property and casualty insurance, home warranty, banking, thrift, trust and investment advisory businesses are regulated by various federal, state and local governmental agencies. Many of the Company's other businesses operate within statutory guidelines. Consequently, the Company may from time to time be subject to examination or investigation by such governmental agencies. Currently, governmental agencies are examining or investigating certain of the Company's operations. These exams or investigations include inquiries into, among other matters, pricing and rate setting practices in the title insurance industry, competition in the title insurance industry, real estate settlement service customer acquisition and retention practices and agency relationships. With respect to matters where the Company has determined that a loss is both probable and reasonably estimable, the Company has recorded a liability representing its best estimate of the financial exposure based on known facts. While the ultimate disposition of each such exam or investigation is not yet determinable, the Company does not believe that individually or in the aggregate they will have a material adverse effect on the Company's financial condition, results of operations or cash flows. These exams or investigations could, however, result in changes to the Company's business practices which could ultimately have a material adverse impact on the Company's financial condition, results of operations or cash flows.

The Company's Canadian operations provide certain services to lenders which it believes to be exempt from excise tax under applicable Canadian tax laws. However, in October 2014, the Canadian taxing authority provided internal guidance that the services in question should be subject to the excise tax. While discussions with the taxing authority are ongoing, the Company believes that the guidance may result in an assessment. The amount, if any, of such assessment is not currently known, and any such assessment would be subject to negotiation. In the event that the Company disagrees with the ultimate assessment, the Company intends to avail itself of avenues of appeal. While the Company believes it is reasonably likely that the Company would prevail on the merits, a loss associated with the matter is possible. In light of the foregoing, the Company is not currently able to reasonably estimate a loss or range of loss associated with the matter. While such a loss could be material to the Company's operating results in any particular period if an unfavorable outcome results, the Company does not believe that this matter will have a material adverse effect on the Company's overall financial condition or liquidity.

The Company and its subsidiaries also are involved in numerous ongoing routine legal and regulatory proceedings related to their operations. With respect to each of these proceedings, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.

During the three and nine months ended September 30, 2016, the Company completed acquisitions for an aggregate purchase price of \$56.9 million and \$75.5 million, respectively. The Company has recorded preliminary fair value estimates for the assets acquired and liabilities assumed, which are subject to change pending completion of the Company's purchase price allocation. The Company allocates the purchase price of each acquisition to the assets acquired and liabilities assumed using a variety of valuation techniques, including discounted cash flow analysis. These acquisitions have been included in the Company's title insurance and services segment.

# FIRST AMERICAN FINANCIAL CORPORATION

## AND SUBSIDIARY COMPANIES

### Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

#### Note 16 – Segment Information

The Company consists of the following reportable segments and a corporate function:

•The Company’s title insurance and services segment issues title insurance policies on residential and commercial property in the United States and offers similar or related products and services internationally. This segment also provides closing and/or escrow services; accommodates tax-deferred exchanges of real estate; provides products, services and solutions involving the use of real property related data designed to mitigate risk or otherwise facilitate real estate transactions; maintains, manages and provides access to title plant records and images; and provides banking, trust and investment advisory services. The Company, through its principal title insurance subsidiary and such subsidiary’s affiliates, transacts its title insurance business through a network of direct operations and agents. Through this network, the Company issues policies in the 49 states that permit the issuance of title insurance policies and the District of Columbia. The Company also offers title insurance and other insurance and guarantee products, as well as related settlement services in foreign countries, including Canada, the United Kingdom, Australia and various other established and emerging markets.

•The Company’s specialty insurance segment issues property and casualty insurance policies and sells home warranty products. The property and casualty insurance business provides insurance coverage to residential homeowners and renters for liability losses and typical hazards such as fire, theft, vandalism and other types of property damage. This business is licensed to issue policies in all 50 states and the District of Columbia and actively issues policies in 47 states. In certain markets it also offers preferred risk auto insurance to better compete with other carriers offering bundled home and auto insurance. The home warranty business provides residential service contracts that cover residential systems, such as heating and air conditioning systems, and appliances against failures that occur as the result of normal usage during the coverage period. This business currently operates in 39 states and the District of Columbia.

The corporate function consists primarily of certain financing facilities as well as the corporate services that support the Company’s business operations. Eliminations consist of inter-segment revenues and related expenses included in the results of the operating segments.

Selected financial information about the Company’s operations, by segment, is as follows:

For the three months ended September 30, 2016:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$1,395,727	\$ 188,706	\$ 22,994	\$ 41,948
Specialty Insurance	109,782	1,781	1,401	844
Corporate	2,855	(23,556 )	96	—
Eliminations	(20 )	—	—	—

Edgar Filing: First American Financial Corp - Form 10-Q

\$ 1,508,344	\$ 166,931	\$ 24,491	\$ 42,792
--------------	------------	-----------	-----------

For the three months ended September 30, 2015:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$1,288,156	\$ 136,984	\$ 19,753	\$ 31,309
Specialty Insurance	101,210	1,684	1,197	927
Corporate	(5,428 )	(23,272 )	122	2
Eliminations	(23 )	—	—	—
	\$1,383,915	\$ 115,396	\$ 21,072	\$ 32,238

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

For the nine months ended September 30, 2016:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$3,750,118	\$ 448,815	\$ 66,510	\$ 99,887
Specialty Insurance	317,246	18,744	4,107	3,928
Corporate	4,265	(71,429 )	288	—
Eliminations	(40 )	—	—	—
	\$4,071,589	\$ 396,130	\$ 70,905	\$ 103,815

For the nine months ended September 30, 2015:

(in thousands)	Revenues	Income (loss) before income taxes	Depreciation and amortization	Capital expenditures
Title Insurance and Services	\$3,534,987	\$ 361,223	\$ 59,443	\$ 91,468
Specialty Insurance	293,398	29,446	3,579	2,804
Corporate	(9,148 )	(74,703 )	367	2
Eliminations	(449 )	—	—	—
	\$3,818,788	\$ 315,966	\$ 63,389	\$ 94,274

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS 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 CAN BE IDENTIFIED BY THE FACT THAT THEY DO NOT RELATE STRICTLY TO HISTORICAL OR CURRENT FACTS AND MAY CONTAIN THE WORDS "BELIEVE," "ANTICIPATE," "EXPECT," "INTEND," "PLAN," "PREDICT," "ESTIMATE," "PROJECT," "WILL BE," "WILL CONTINUE," "WILL LIKELY RESU OTHER SIMILAR WORDS AND PHRASES OR FUTURE OR CONDITIONAL VERBS SUCH AS "WILL," "MAY," "MIGHT," "SHOULD," "WOULD," OR "COULD." THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS REGARDING FUTURE OPERATIONS, PERFORMANCE, FINANCIAL CONDITION, PROSPECTS, PLANS AND STRATEGIES. THESE FORWARD-LOOKING STATEMENTS ARE BASED ON CURRENT EXPECTATIONS AND ASSUMPTIONS THAT MAY PROVE TO BE INCORRECT.

RISKS AND UNCERTAINTIES EXIST THAT MAY CAUSE RESULTS TO DIFFER MATERIALLY FROM THOSE SET FORTH IN THESE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE THE ANTICIPATED RESULTS TO DIFFER FROM THOSE DESCRIBED IN THE FORWARD-LOOKING STATEMENTS INCLUDE THE FACTORS SET FORTH ON PAGES 3-4 OF THIS QUARTERLY REPORT. THE FORWARD-LOOKING STATEMENTS SPEAK ONLY AS OF THE DATE THEY ARE MADE. THE COMPANY DOES NOT UNDERTAKE TO UPDATE FORWARD-LOOKING STATEMENTS TO REFLECT CIRCUMSTANCES OR EVENTS THAT OCCUR AFTER THE DATE THE FORWARD-LOOKING STATEMENTS ARE MADE.

This Management's Discussion and Analysis contains certain financial measures that are not presented in accordance with U.S. generally accepted accounting principles ("GAAP"), including adjusted information and other revenues, adjusted personnel costs and adjusted other operating expenses, in each case excluding the effects of recent acquisitions. The Company is presenting these non-GAAP financial measures because they provide the Company's management and readers of this Quarterly Report on Form 10-Q with additional insight into the operational performance of the Company relative to earlier periods. The Company does not intend for these non-GAAP financial measures to be a substitute for any GAAP financial information. In this Quarterly Report on Form 10-Q, these non-GAAP financial measures have been presented with, and reconciled to, the most directly comparable GAAP financial measures. Readers of this Quarterly Report on Form 10-Q should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial measures.

#### CRITICAL ACCOUNTING ESTIMATES

There have been no material changes to the Company's critical accounting estimates since the filing of its Annual Report on Form 10-K for the year ended December 31, 2015. A summary of the Company's accounting policies that it considers to be the most dependent on the application of estimates and assumptions can be found in the Management's Discussion and Analysis section of the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

#### Recently Adopted Accounting Pronouncements

In September 2015, the Financial Accounting Standards Board ("FASB") issued updated guidance intended to simplify the accounting for adjustments made to provisional amounts recognized in a business combination and eliminates the requirement to retrospectively account for those adjustments. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015 and applies prospectively to adjustments made to provisional amounts that occur after the effective date of this guidance with early adoption permitted for financial statements that

have not been issued. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In August 2015, the FASB issued updated guidance relating to the Securities and Exchange Commission Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting on the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements. The updated guidance allows for the deferral and presentation of debt issuance costs as an asset which may be amortized ratably over the term of the line-of-credit arrangement, regardless of whether there are any related outstanding borrowings. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In May 2015, the FASB issued updated guidance intended to eliminate the diversity in practice surrounding how investments measured at net asset value under the practical expedient with future redemption dates have been categorized in the fair value hierarchy. Under the updated guidance, investments for which fair value is measured at net asset value per share using the practical expedient should no longer be categorized in the fair value hierarchy. The updated guidance requires retrospective adoption for all periods presented and is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In April 2015, the FASB issued updated guidance intended to clarify the accounting treatment for cloud computing arrangements that include software licenses. Under the updated guidance, if a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The Company elected to adopt the updated guidance prospectively for all arrangements entered into or materially modified after the effective date. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements. The financial statement line items impacted by the adoption of the updated guidance include other intangible assets, net and depreciation and amortization. See Note 5 Other Intangible Assets to the condensed consolidated financial statements for further information on the Company's internal-use software licenses.

In April 2015, the FASB issued updated guidance intended to simplify, and provide consistency to, the presentation of debt issuance costs. The new standard requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements.

In February 2015, the FASB issued updated guidance which changes the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In June 2014, the FASB issued updated guidance intended to eliminate the diversity in practice regarding share-based payment awards that include terms which provide for a performance target that affects vesting being achieved after the requisite service period. The new standard requires that a performance target which affects vesting and could be achieved after the requisite service period be treated as a performance condition that affects vesting and should not be reflected in estimating the grant-date fair value. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

#### Pending Accounting Pronouncements

In August 2016, the FASB issued updated guidance intended to eliminate the diversity in practice regarding the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated statement of cash flows.



In June 2016, the FASB issued updated guidance intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The updated guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires the consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In May 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance includes narrow-scope improvements intended to address implementation issues and to provide additional practical expedients in the guidance. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In April 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance is intended to reduce the cost and complexity of applying the guidance on identifying promised goods or services in a contract and to improve the operability and understandability of the implementation guidance regarding the licensing of intellectual property. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to simplify and improve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of such awards as either equity or liabilities and classification on the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance is intended to improve the operability and understandability of the implementation guidance regarding principal versus agent considerations in a contract. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to simplify the accounting treatment for investments that become qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company expects the adoption of this guidance to have no impact on its condensed consolidated financial statements.

In February 2016, the FASB issued updated guidance that requires the rights and obligations associated with leasing arrangements be reflected on the balance sheet in order to increase transparency and comparability among organizations. Under the updated guidance, lessees will be required to recognize a right-of-use asset and a liability to make lease payments and disclose key information about leasing arrangements. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In January 2016, the FASB issued updated guidance intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. In addition to making other targeted improvements to current guidance, the updated guidance also requires all equity investments, except those accounted for under the equity method of accounting or those that result in consolidation of the investee, to be measured at fair value with changes in the fair value recognized through net income. The updated guidance is effective for interim and

annual reporting periods beginning after December 15, 2017, with early adoption permitted in certain circumstances. While the Company expects the adoption of this guidance to impact its condensed consolidated statements of income, the materiality of the impact will depend upon the size of, and level of volatility experienced within, the Company's equity portfolio.

In May 2015, the FASB issued updated disclosure guidance related to short-duration contracts issued by insurance entities. The updated guidance is intended to increase the transparency of significant estimates made in measuring liabilities for unpaid claims and claim adjustment expenses and to provide additional insight into an insurance entity's ability to underwrite and anticipate costs associated with claims. The updated guidance is effective for annual reporting periods beginning after December 15, 2015 and for interim periods within annual periods beginning after December 15, 2016, with early adoption permitted. Except for the disclosure requirements, the Company does not expect the adoption of this guidance to impact its condensed consolidated financial statements.

In May 2014, the FASB issued updated guidance for recognizing revenue from contracts with customers to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within and across industries, and across capital markets. The new revenue standard contains principles that an entity will apply to determine the measurement of revenue and the timing of recognition. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. Revenue from insurance contracts is not within the scope of this guidance. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption prohibited. In August 2015, the FASB issued updated guidance which defers the effective date of this guidance by one year to interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted as of the original effective date. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

## Results of Operations

### Summary of Third Quarter

A substantial portion of the revenues for the Company's title insurance and services segment results from the sale and refinancing of residential and commercial real estate. In the Company's specialty insurance segment, revenues associated with the initial year of coverage in both the home warranty and property and casualty operations are impacted by volatility in residential purchase transactions. Traditionally, the greatest volume of real estate activity, particularly residential purchase activity, has occurred in the spring and summer months. However, changes in interest rates, as well as other changes in general economic conditions in the United States and abroad, can cause fluctuations in the traditional pattern of real estate activity.

The Company's total revenues increased \$124.4 million, or 9.0%, in the third quarter of 2016 when compared with the third quarter of 2015. This increase was primarily attributable to an increase in agent premiums and, to a lesser extent, an increase in direct premiums and escrow fees from residential refinance transactions in the title insurance and services segment. Agent premiums increased \$40.0 million, or 6.8%, and direct premiums and escrow fees from residential refinance transactions increased \$33.4 million, or 52.8%, in the third quarter of 2016 when compared to the third quarter of 2015.

According to the Mortgage Bankers Association's September 12, 2016 Mortgage Finance Forecast (the "MBA Forecast"), residential mortgage originations in the United States (based on the total dollar value of the transactions) increased 31.7% in the third quarter of 2016 when compared with the third quarter of 2015. According to the MBA Forecast, the dollar amount of purchase originations increased 9.2% and refinance originations increased 71.9%. This volume of domestic residential mortgage origination activity contributed to a 3.2% increase in direct premiums and escrow fees from domestic residential purchase transactions and a 52.8% increase in direct premiums and escrow fees from domestic refinance transactions in the third quarter of 2016 when compared to the third quarter of 2015.

During the third quarter of 2016, the level of domestic title orders opened per day by the Company's direct title operations increased by 17.4% when compared with the third quarter of 2015. Residential refinance and purchase orders opened per day increased by 58.0% and 0.5%, respectively, and commercial orders opened per day decreased by 7.5%.

In May 2016, the Company's board of directors terminated the Company's funded defined benefit pension plan effective as of July 31, 2016. Once the termination process is complete, the Company estimates an annual reduction of approximately \$22 million in personnel costs related to the pension plan within the corporate segment, based on the level of these expenses for the nine months ended September 30, 2016. For further discussion of the pension termination including the recent and expected contribution amounts and the timing of pension termination expenses to

be recognized, see Note 10 Employee Benefit Plans to the condensed consolidated financial statements.

The Company recorded certain reclassifications and revisions to its condensed consolidated statements of income for the three and nine months ended September 30, 2015. For further discussion of these reclassifications and revisions, see Note 1 Basis of Condensed Consolidated Financial Statements.

# Title Insurance and Services

	Three Months Ended September 30,				Nine Months Ended September 30,			
(thousands, except percentages)	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Revenues								
Direct premiums and escrow	\$544,427	\$507,390	\$37,037	7.3 %	\$1,471,338	\$1,433,941	\$37,397	2.6 %
Agent premiums	625,953	585,974	39,979	6.8	1,653,990	1,520,507	133,483	8.8
Commission and other	187,979	172,560	15,419	8.9	524,199	508,932	15,267	3.0
Investment income	28,986	25,381	3,605	14.2	81,389	73,151	8,238	11.3
Realized investment gains (losses)	8,382	(3,149 )	11,531	366.2	19,202	(1,544 )	20,746	NM
Expenses	1,395,727	1,288,156	107,571	8.4	3,750,118	3,534,987	215,131	6.1
Personnel costs	409,345	390,133	19,212	4.9	1,154,225	1,110,410	43,815	3.9
Commissions retained by agents	495,130	462,535	32,595	7.0	1,303,838	1,200,549	103,289	8.6
Other operating expenses	198,147	190,721	7,426	3.9	559,141	565,605	(6,464 )	(1.1)
Provision for policy losses and claims	64,352	71,768	(7,416 )	(10.3 )	171,994	194,053	(22,059 )	(11.4)
Depreciation and amortization	22,994	19,753	3,241	16.4	66,510	59,443	7,067	11.9
Premium taxes	16,301	15,612	689	4.4	43,488	41,836	1,652	3.9
Interest	752	650	102	15.7	2,107	1,868	239	12.8
Income before income taxes	1,207,021	1,151,172	55,849	4.9	3,301,303	3,173,764	127,539	4.0
Income taxes	\$188,706	\$136,984	\$51,722	37.8 %	\$448,815	\$361,223	\$87,592	24.2 %
Income	13.5 %	10.6 %	2.9 %	27.4 %	12.0 %	10.2 %	1.8 %	17.6 %

(1) Not meaningful

Direct premiums and escrow fees were \$544.4 million and \$1.5 billion for the three and nine months ended September 30, 2016, respectively, increases of \$37.0 million, or 7.3%, and \$37.4 million, or 2.6%, when compared with the respective periods of the prior year. The increases for the three and nine months ended September 30, 2016 were primarily due to an increase in domestic title orders closed, partially offset by a decrease in average revenues per order closed. The average revenues per order closed were \$1,859 and \$1,921 for the three and nine months ended September 30, 2016, respectively, decreases of 10.5% and 1.2% when compared with \$2,077 and \$1,945 for the respective periods of the prior year. The decreases in average revenues per order closed for the three and nine months ended September 30, 2016 were primarily attributable to a shift in the mix of direct revenues generated from higher premium commercial products to lower premium residential refinance products. The Company's direct title operations closed 268,400 and 705,700 title orders during the three and nine months ended September 30, 2016, respectively, increases of 19.8% and 4.1% when compared with 224,000 and 678,100 title orders closed during the respective periods of the prior year.

Agent premiums were \$626.0 million and \$1.7 billion for the three and nine months ended September 30, 2016, respectively, increases of \$40.0 million, or 6.8%, and \$133.5 million, or 8.8%, when compared with the respective periods of the prior year. Agent premiums are recorded when notice of issuance is received from the agent, which is generally when cash payment is received by the Company. As a result, there is generally a delay between the agent's issuance of a title policy and the Company's recognition of agent premiums. Therefore, current quarter agent premiums

typically reflect prior quarter mortgage origination activity. The increase in agent premiums quarter over quarter was generally consistent with the 1.5% increase in the Company's direct premiums and escrow fees in the second quarter of 2016 as compared with the second quarter of 2015.

Information and other revenues primarily consist of revenues generated from fees associated with title search and related reports, title and other real property records and images, other non-insured settlement services, and risk mitigation products and services. These revenues generally trend with direct premiums and escrow fees but are typically less volatile since a portion of the revenues are subscription based and do not fluctuate with transaction volumes.

Information and other revenues were \$188.0 million and \$524.2 million for the three and nine months ended September 30, 2016, respectively, increases of \$15.4 million, or 8.9%, and \$15.3 million, or 3.0%, when compared with the respective periods of the prior year. Excluding the \$10.3 million and \$20.9 million impact of new acquisitions for the three and nine months ended September 30, 2016, respectively, information and other revenues increased \$5.1 million, or 3.0%, and decreased \$5.6 million, or 1.1%, when compared with the respective periods of the prior year. The increase in information and other revenues for the three months ended September 30, 2016, adjusted for the impact of acquisitions, was due to higher demand for the Company's title plant and data products, partially offset by lower revenue in the Company's Australian operations due to the loss of a large customer. The decrease in information and other revenues for the nine months ended September 30, 2016, adjusted for the impact of acquisitions, was due to lower demand for the Company's default information products as a result of the decrease in domestic loss mitigation activities and lower revenue in the Company's Australian operations due to the loss of a large customer, partially offset by higher demand for the Company's title plant and data products.

Net investment income totaled \$29.0 million and \$81.4 million for the three and nine months ended September 30, 2016, respectively, increases of \$3.6 million, or 14.2%, and \$8.2 million, or 11.3%, when compared with the respective periods of the prior year. The increases were primarily attributable to higher interest income from the investment portfolio due to higher average balances in the title insurance and services segment's debt securities portfolio, partially offset by lower income from investments accounted for using the equity method when compared to the same periods of the prior year.

Net realized investment gains totaled \$8.4 million and \$19.2 million for the three and nine months ended September 30, 2016, respectively, and were primarily from the sales of debt and equity securities. Net realized investment gains for the nine months ended September 30, 2016 also included gains from the sales of real estate and certain regional operations. Net realized investment losses totaled \$3.1 million for the three months ended September 30, 2015 and were primarily attributable to a loss from the sale of a wholly-owned subsidiary. Net realized investment losses totaled \$1.5 million for the nine months ended September 30, 2015 and were primarily related to impairment on internally developed software of \$7.3 million, net realized losses from the sales of equity securities of \$4.0 million, partially offset by gains from the sales of real estate of \$9.4 million.

The title insurance and services segment (primarily direct operations) is labor intensive; accordingly, a major expense component is personnel costs. This expense component is affected by two primary factors: the need to monitor personnel changes to match the level of corresponding or anticipated new orders and the need to provide quality service.

Personnel costs were \$409.3 million and \$1.2 billion for the three and nine months ended September 30, 2016, respectively, increases of \$19.2 million, or 4.9%, and \$43.8 million, or 3.9%, when compared with the respective periods of the prior year. Excluding the \$8.2 million and \$16.8 million impact of new acquisitions for the three and nine months ended September 30, 2016, respectively, personnel costs increased \$11.0 million, or 2.8%, and \$27.0 million, or 2.4%, when compared with the respective periods of the prior year. The increases in personnel costs for the three and nine months ended September 30, 2016, adjusted for the impact of new acquisitions, were primarily attributable to higher salary, share based compensation, incentive compensation, and employee benefits expense. The higher salary costs were due to an increase in average salaries and, to a lesser extent, higher average headcount. The higher share based compensation costs were due to increased restricted stock units granted to employees during the first quarter of 2016 associated with 2015 performance. The increases in incentive compensation expense were due to higher commissions paid on higher revenues, partially offset by lower expected 401(k) savings plan matches. The increases in employee benefits expense were primarily due to higher paid medical claims when compared to the same period of the prior year.



Agents retained \$495.1 million and \$1.3 billion of title premiums generated by agency operations for the three and nine months ended September 30, 2016, respectively, which compares with \$462.5 million and \$1.2 billion for the respective periods of the prior year. The percentage of title premiums retained by agents was 79.1% and 78.8% for the three and nine months ended September 30, 2016, respectively, compared to 78.9% and 79.0% for the respective periods of the prior year. The increase in the percentage of title premiums retained by agents for the three months ended September 30, 2016 was due to a change in the geographic mix of agency revenues towards higher agent-retention geographies. The decrease in the percentage of title premiums retained by agents for the nine months ended September 30, 2016 was due to a change in the geographic mix of agency revenues towards lower agent-retention geographies.

Other operating expenses for the title insurance and services segment were \$198.1 million and \$559.1 million for the three and nine months ended September 30, 2016, respectively, an increase of \$7.4 million, or 3.9%, and a decrease of \$6.5 million, or 1.1%, when compared with the respective periods of the prior year. Excluding the \$2.1 million and \$4.4 million impact of new acquisitions for the three and nine months ended September 30, 2016, respectively, other operating expenses increased \$5.3 million, or 2.8%, and decreased \$10.9 million, or 1.9%, when compared with the respective periods of the prior year. The increase in other operating expenses for the three months ended September 30, 2016, adjusted for the impact of new acquisitions, was primarily attributable to higher production related costs due to higher order volumes. The decrease in other operating expenses for the nine months ended September 30, 2016, adjusted for the impact of new acquisitions, was primarily attributable to lower production related costs, lower bad debt expense, lower foreign currency exchange losses and a recovery on an insurance claim. Production related costs for the nine months ended September 30, 2016 declined due to an increase in the mix of revenues generated from products with lower production related expenses as a percentage of revenue.

The provision for policy losses and other claims, expressed as a percentage of title insurance premiums and escrow fees, was 5.5% for the three and nine months ended September 30, 2016 compared to 6.6% for the three and nine months ended September 30, 2015. The current quarter rate of 5.5% reflects the ultimate loss rate of 5.0% for the current policy year and a \$5.8 million net increase in the loss reserve estimates for prior policy years. The third quarter of 2015 rate of 6.6% reflected the ultimate loss rate of 6.0% for the 2015 policy year and a \$6.2 million net increase in the loss reserve estimates for prior policy years.

Depreciation and amortization expense was \$23.0 million and \$66.5 million for the three and nine months ended September 30, 2016, respectively, increases of \$3.2 million, or 16.4%, and \$7.1 million, or 11.9%, when compared with the respective periods of the prior year. The increases in depreciation and amortization for the three and nine months ended September 30, 2016 were primarily attributable to the amortization expense associated with internally developed technology and purchased software licenses.

Premium taxes were \$16.3 million and \$43.5 million for the three and nine months ended September 30, 2016, respectively, increases of \$700 thousand, or 4.4%, and \$1.7 million, or 3.9%, respectively, compared to \$15.6 million and \$41.8 million for the same periods of the prior year. Premium taxes as a percentage of title insurance premiums and escrow fees were 1.4% for the three and nine months ended September 30, 2016 and 2015.

The profit margins for the title insurance business reflect the high cost of performing the essential services required before insuring title, whereas the corresponding revenues are subject to regulatory and competitive pricing restraints. Due to this relatively high proportion of fixed costs, title insurance profit margins generally improve as closed order volumes increase. Title insurance profit margins are affected by the composition (residential or commercial) and type (resale, refinancing or new construction) of real estate activity. Title insurance profit margins are also affected by the percentage of title insurance premiums generated by agency operations. Profit margins from direct operations are generally higher than from agency operations due primarily to the large portion of the premium that is retained by the agent. Pre-tax margins for the three and nine months ended September 30, 2016 were 13.5% and 12.0%, respectively, compared with 10.6% and 10.2% in the respective periods of the prior year.

## Specialty Insurance

(in thousands, except percentages)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
<b>Revenues</b>								
Direct premiums	\$105,299	\$98,060	\$7,239	7.4 %	\$304,277	\$282,527	\$21,750	7.7 %
Information and other	754	795	(41 )	(5.2 )	2,394	2,422	(28 )	(1.2 )
Net investment income	2,595	2,336	259	11.1	7,085	6,552	533	8.1
Net realized investment gains	1,134	19	1,115	NM <sup>1</sup>	3,490	1,897	1,593	84.0
	109,782	101,210	8,572	8.5	317,246	293,398	23,848	8.1
<b>Expenses</b>								
Personnel costs	17,347	17,089	258	1.5	51,149	49,530	1,619	3.3
Other operating expenses	14,603	12,055	2,548	21.1	43,563	36,262	7,301	20.1
Provision for policy losses and other claims	72,663	67,358	5,305	7.9	194,479	169,497	24,982	14.7
Depreciation and amortization	1,401	1,197	204	17.0	4,107	3,579	528	14.8
Premium taxes	1,987	1,827	160	8.8	5,204	5,084	120	2.4
	108,001	99,526	8,475	8.5	298,502	263,952	34,550	13.1
Income before income taxes	\$1,781	\$1,684	\$97	5.8 %	\$18,744	\$29,446	\$(10,702)	(36.3)%
Margins	1.6 %	1.7 %	(0.1 )%	(5.9 )%	5.9 %	10.0 %	(4.1 )%	(41.0)%

(1) Not meaningful

Direct premiums were \$105.3 million and \$304.3 million for the three and nine months ended September 30, 2016, respectively, increases of \$7.2 million, or 7.4%, and \$21.8 million, or 7.7%, when compared with the respective periods of the prior year. The increases in direct premiums for the three and nine months ended September 30, 2016 were attributable to higher premiums earned in the home warranty business driven by an increase in the price charged for home warranty residential service contracts and an increase in the number of contracts issued.

Net realized investment gains totaled \$1.1 million and \$3.5 million for the three and nine months ended September 30, 2016, respectively, and \$19 thousand and \$1.9 million for the three and nine months ended September 30, 2015, respectively, and were primarily from the sales of debt and equity securities. Net realized investment gains for the nine months ended September 30, 2016 also included gains from the sale of real estate.

Personnel costs and other operating expenses were \$32.0 million and \$94.7 million for the three and nine months ended September 30, 2016, respectively, increases of \$2.8 million, or 9.6%, and \$8.9 million, or 10.4%, when compared with the respective periods of the prior year. The increases were primarily related to higher advertising expense in the home warranty business, higher offshore labor expense related to increased customer support activities associated with the increased volume in the home warranty business, and higher salary expense due to higher average salaries.

The provision for home warranty claims, expressed as a percentage of home warranty premiums, was 69.8% and 63.4% for the three and nine months ended September 30, 2016, respectively, compared with 64.8% and 57.4% for the respective periods of the prior year. The increases in the claims rates for the three and nine months ended September 30, 2016 were primarily attributable to higher contract servicing costs. The provision for property and casualty claims, expressed as a percentage of property and casualty insurance premiums, was 67.3% and 65.0% for the three and nine months ended September 30, 2016, respectively, compared with 77.0% and 65.2% for the respective

periods of the prior year. The decrease in the claims rate for the three months ended September 30, 2016 was primarily attributable to a decrease in the severity of claims and a decline in weather-related loss events, partially offset by higher claims frequency. The claims rate for the three months ended September 30, 2015 was impacted by a wildfire in northern California.

Premium taxes were \$2.0 million and \$5.2 million for the three and nine months ended September 30, 2016, respectively, compared with \$1.8 million and \$5.1 million for the respective periods of the prior year. Premium taxes as a percentage of specialty insurance segment premiums were 1.9% and 1.7% for the three and nine months ended September 30, 2016, respectively, and 1.9% and 1.8% for the three and nine months ended September 30, 2015, respectively.

A large part of the revenues for the specialty insurance businesses are generated by renewals and are not dependent on the level of real estate activity in the year of renewal. With the exception of loss expense, the majority of the expenses for this segment are variable in nature and therefore generally fluctuate consistent with revenue fluctuations.

Accordingly, profit margins for this segment (before loss expense) are relatively constant, although as a result of some fixed expenses, profit margins (before loss expense) should nominally improve as premium revenues increase. Pre-tax margins for the three and nine months ended September 30, 2016 were 1.6% and 5.9%, respectively, compared with 1.7% and 10.0% in the respective periods of the prior year.

## Corporate

(in thousands, except percentages)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
<b>Revenues</b>								
Net investment income (losses)	\$2,855	\$(5,428)	\$8,283	152.6%	\$4,265	\$(8,580)	\$12,845	149.7%
Net realized investment losses	—	—	—	—	—	(568)	568	100.0
	2,855	(5,428)	8,283	152.6	4,265	(9,148)	13,413	146.6
<b>Expenses</b>								
Personnel costs	12,000	4,521	7,479	165.4	33,755	25,378	8,377	33.0
Other operating expenses	7,215	6,546	669	10.2	20,309	19,451	858	4.4
Depreciation and amortization	96	122	(26)	(21.3)	288	367	(79)	(21.5)
Interest	7,100	6,655	445	6.7	21,342	20,359	983	4.8
	26,411	17,844	8,567	48.0	75,694	65,555	10,139	15.5
Loss before income taxes	\$(23,556)	\$(23,272)	\$(284)	(1.2)%	\$(71,429)	\$(74,703)	\$3,274	4.4%

Net investment income totaled \$2.9 million and \$4.3 million for the three and nine months ended September 30, 2016, respectively, compared with losses of \$5.4 million and \$8.6 million for the respective periods of the prior year. The increases in net investment income for the three and nine months ended September 30, 2016 were primarily attributable to higher earnings on investments associated with the Company's deferred compensation plan when compared to the same periods of 2015. Net investment losses for the nine months ended September 30, 2015 were also impacted by a one-time non-cash expense of \$4.0 million, recorded during the first quarter of 2015, related to the investments associated with the Company's deferred compensation plan.

Corporate personnel costs and other operating expenses were \$19.2 million and \$54.1 million for the three and nine months ended September 30, 2016, respectively, compared with \$11.1 million and \$44.8 million for the respective periods of the prior year. The increases in personnel costs and other operating expenses for the three and nine months ended September 30, 2016 were primarily attributable to increased expense related to the Company's deferred compensation plan.

## Eliminations

The Company's inter-segment eliminations were not material for the three and nine months ended September 30, 2016 and 2015.

## INCOME TAXES

The Company's effective income tax rates (income tax expense as a percentage of income before income taxes) were 35.7% and 33.7% for the three and nine months ended September 30, 2016, respectively, compared with 34.3% and 34.4% for the respective periods of the prior year. The differences in the effective tax rates were primarily due to changes in state and foreign income taxes resulting from fluctuations in the Company's noninsurance and foreign subsidiaries' contribution to pretax income and changes in the ratio of permanent differences to income before income

taxes. The rates for both the three and nine months ended September 30, 2016 reflect the resolution of certain tax authority examinations and tax credits claimed in current and prior years.

The Company evaluates the realizability of its deferred tax assets by assessing the valuation allowance and adjusts the allowance, as necessary. The factors used to assess the likelihood of realization are the Company's forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. The ability or failure to achieve the forecasted taxable income in the applicable taxing jurisdictions could affect the ultimate realization of deferred tax assets. Based on future operating results in certain jurisdictions, it is possible that the current valuation allowance positions of those jurisdictions could be adjusted in the next 12 months.

#### NET INCOME AND NET INCOME ATTRIBUTABLE TO THE COMPANY

Net income for the three and nine months ended September 30, 2016 was \$107.4 million and \$262.5 million, respectively, compared with \$75.8 million and \$207.1 million for the respective periods of the prior year. Net income attributable to the Company for the three and nine months ended September 30, 2016 was \$107.3 million, or \$0.96 per diluted share, and \$262.0 million, or \$2.36 per diluted share, respectively, compared with \$75.5 million, or \$0.69 per diluted share, and \$206.5 million, or \$1.88 per diluted share, for the respective periods of the prior year.

#### LIQUIDITY AND CAPITAL RESOURCES

**Cash requirements.** The Company generates cash primarily from the sale of its products and services and investment income. The Company's current cash requirements include operating expenses, taxes, payments of principal and interest on its debt, capital expenditures, dividends on its common stock and business acquisitions, and may include repurchases of its common stock. Additionally, in May 2016, the Company's board of directors terminated the Company's funded defined benefit pension plan effective as of July 31, 2016. In connection with the termination, to sufficiently fund the pension plan, the Company contributed an additional cash contribution of \$55.9 million in September 2016 and expects to make an additional cash contribution of approximately \$44 million. The Company also expected to pay other termination related expenses. For further discussion of the pension termination and expected additional cash contributions, see Note 10 Employee Benefit Plans to the condensed consolidated financial statements. Management forecasts the cash needs of the holding company and its primary subsidiaries and regularly reviews their short-term and long-term projected sources and uses of funds, as well as the asset, liability, investment and cash flow assumptions underlying such forecasts. Due to the Company's ability to generate cash flows from operations, its liquid-asset position and amounts available on its revolving credit facility, management believes that its resources are sufficient to satisfy its anticipated operational cash requirements and obligations for at least the next twelve months.

The substantial majority of the Company's business is dependent upon activity in the real estate and mortgage markets, which are cyclical and seasonal. Periods of increasing interest rates and reduced mortgage financing availability generally have an adverse effect on residential real estate activity and therefore typically decrease the Company's revenues. In contrast, periods of declining interest rates and increased mortgage financing availability generally have a positive effect on residential real estate activity which typically increases the Company's revenues. Residential purchase activity is typically slower in the winter months with increased volumes in the spring and summer months. Residential refinance activity is typically more volatile than purchase activity and is highly impacted by changes in interest rates. Commercial real estate volumes are less sensitive to changes in interest rates, but fluctuate based on local supply and demand conditions for space and mortgage financing availability.

Cash provided by operating activities amounted to \$252.2 million and \$352.2 million for the nine months ended September 30, 2016 and 2015, respectively, after claim payments, net of recoveries, of \$351.3 million and \$364.3 million, respectively. The principal nonoperating uses of cash and cash equivalents for the nine months ended September 30, 2016 and 2015 were purchases of debt and equity securities, capital expenditures, dividends to common stockholders and business acquisitions. The most significant nonoperating sources of cash and cash equivalents for the nine months ended September 30, 2016 were proceeds from the sales and maturities of debt and

equity securities, increases in the deposit balances at the Company's banking operations and net proceeds from the issuance of debt. The most significant nonoperating sources of cash and cash equivalents for the nine months ended September 30, 2015 were proceeds from the sales and maturities of debt and equity securities and increases in the deposit balances at the Company's banking operations. The net effect of all activities on total cash and cash equivalents was an increase of \$416.0 million for the nine months ended September 30, 2016 and a decrease of \$295.7 million for the nine months ended September 30, 2015.



The Company continually assesses its capital allocation strategy, including decisions relating to dividends, stock repurchases, capital expenditures, acquisitions and investments. In August 2016, the Company's board of directors approved an increase in the Company's quarterly cash dividend to 34 cents per common share, representing a 31% increase from the prior level of 26 cents per common share. The dividend increase became effective beginning with the September 2016 dividend. Management expects that the Company will continue to pay quarterly cash dividends at or above the current level. The timing, declaration and payment of future dividends, however, falls within the discretion of the Company's board of directors and will depend upon many factors, including the Company's financial condition and earnings, the capital requirements of the Company's businesses, restrictions imposed by applicable law and any other factors the board of directors deems relevant from time to time.

In March 2014, the Company's board of directors approved an increase in the size of the Company's stock repurchase plan from \$150.0 million to \$250.0 million, of which \$182.4 million remained as of September 30, 2016. Purchases may be made from time to time by the Company in the open market at prevailing market prices or in privately negotiated transactions. During the nine months ended September 30, 2016, the Company repurchased and retired 14 thousand shares of its common stock for a total purchase price of \$454 thousand and as of September 30, 2016, had repurchased and retired 3.2 million shares of its common stock under the current authorization for a total purchase price of \$67.6 million.

**Holding Company.** First American Financial Corporation is a holding company that conducts all of its operations through its subsidiaries. The holding company's current cash requirements include payments of principal and interest on its debt, taxes, payments in connection with employee benefit plans, dividends on its common stock and other expenses. The holding company is dependent upon dividends and other payments from its operating subsidiaries to meet its cash requirements. The Company's target is to maintain a cash balance at the holding company equal to at least twelve months of estimated cash requirements. At certain points in time, the actual cash balance at the holding company may vary from this target due to, among other factors, the timing and amount of cash payments made and dividend payments received. Pursuant to insurance and other regulations under which the Company's insurance subsidiaries operate, the amount of dividends, loans and advances available to the holding company is limited, principally for the protection of policyholders. As of September 30, 2016, under such regulations, the maximum amount of dividends, loans and advances available to the holding company from its insurance subsidiaries for the remainder of 2016, without prior approval from applicable regulators, was \$549.1 million. However, the timing and amount of dividends paid by the Company's insurance subsidiaries to the holding company falls within the discretion of each insurance subsidiary's board of directors and will depend upon many factors, including the level of total statutory capital and surplus required to support minimum financial strength ratings by certain rating agencies. Such restrictions have not had, nor are they expected to have, an impact on the holding company's ability to meet its cash obligations.

As of September 30, 2016, the holding company's sources of liquidity included \$244.0 million of cash and cash equivalents and \$540.0 million available on the Company's revolving credit facility. Management believes that liquidity at the holding company is sufficient to satisfy anticipated cash requirements and obligations for at least the next twelve months.

**Financing.** The Company maintains a credit agreement with JPMorgan Chase Bank, N.A. in its capacity as administrative agent and the lenders party thereto. The credit agreement is comprised of a \$700.0 million revolving credit facility. Unless terminated earlier, the revolving loan commitments under the credit agreement will terminate on May 14, 2019. The obligations of the Company under the credit agreement are neither secured nor guaranteed. Proceeds under the credit agreement may be used for general corporate purposes. At September 30, 2016, the Company was in compliance with the financial covenants under the credit agreement.

In September 2016, the Company borrowed \$160.0 million under the credit facility to fund acquisitions and to partially fund its obligation in connection with the termination of its pension plan. At September 30, 2016, outstanding borrowings under the facility totaled \$160.0 million at an interest rate of 2.28%. See Note 15 Business Combinations to the condensed consolidated financial statements for further discussion of the Company's acquisitions, and see Note 10 Employee Benefit Plans to the condensed consolidated financial statements for further discussion of the Company's pension termination.

In addition to amounts available under its credit facility, certain subsidiaries of the Company are parties to master repurchase agreements which are used as part of the Company's liquidity management activities and to support its risk management activities. In particular, securities loaned or sold under repurchase agreements may be used as short-term funding sources. During the nine months ended September 30, 2016, the Company financed securities for funds received totaling \$39.2 million under these agreements. As of September 30, 2016, no amounts remained outstanding under these agreements.

Notes and contracts payable as a percentage of total capitalization was 19.6% and 17.5% at September 30, 2016 and December 31, 2015, respectively.

**Investment Portfolio.** The Company maintains a high quality, liquid investment portfolio that is primarily held at its insurance and banking subsidiaries. As of September 30, 2016, 92% of the Company's investment portfolio consisted of fixed income securities, of which 61% were United States government-backed or rated AAA and 94% were rated or classified as investment grade. Percentages are based on the estimated fair values of the securities. Credit ratings reflect published ratings obtained from Standard & Poor's Rating Services, DBRS, Inc., Fitch Ratings, Inc. and Moody's Investor Service, Inc. If a security was rated differently among the rating agencies, the lowest rating was selected. For further information on the credit quality of the Company's investment portfolio at September 30, 2016, see Note 3 Debt and Equity Securities to the condensed consolidated financial statements.

In addition to its debt and equity securities portfolio, the Company maintains certain money-market and other short-term investments.

**Off-balance sheet arrangements.** The Company administers escrow deposits and trust assets as a service to its customers. Escrow deposits totaled \$7.5 billion and \$6.6 billion at September 30, 2016 and December 31, 2015, respectively, of which \$3.1 billion and \$2.6 billion, respectively, were held at the Company's federal savings bank subsidiary, First American Trust, FSB. The escrow deposits held at First American Trust, FSB are temporarily invested in cash and cash equivalents and debt securities, with offsetting liabilities included in deposits in the accompanying condensed consolidated balance sheets. The remaining escrow deposits were held at third-party financial institutions.

Trust assets held or managed by First American Trust, FSB totaled \$3.2 billion and \$3.0 billion at September 30, 2016 and December 31, 2015, respectively. Escrow deposits held at third-party financial institutions and trust assets are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. However, the Company could be held contingently liable for the disposition of these assets.

In conducting its operations, the Company often holds customers' assets in escrow, pending completion of real estate transactions and, as a result, the Company has ongoing programs for realizing economic benefits with various financial institutions. The results from these programs are included in the condensed consolidated financial statements as income or a reduction in expense, as appropriate, based on the nature of the arrangement and benefit received.

The Company facilitates tax-deferred property exchanges for customers pursuant to Section 1031 of the Internal Revenue Code and tax-deferred reverse exchanges pursuant to Revenue Procedure 2000-37. As a facilitator and intermediary, the Company holds the proceeds from sales transactions and takes temporary title to property identified by the customer to be acquired with such proceeds. Upon the completion of each such exchange, the identified property is transferred to the customer or, if the exchange does not take place, an amount equal to the sales proceeds or, in the case of a reverse exchange, title to the property held by the Company is transferred to the customer. Like-kind exchange funds held by the Company totaled \$2.2 billion and \$2.8 billion at September 30, 2016 and December 31, 2015, respectively. The like-kind exchange deposits are held at third-party financial institutions and, due to the structure utilized to facilitate these transactions, the proceeds and property are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. All such amounts are placed in deposit accounts insured, up to applicable limits, by the Federal Deposit Insurance Corporation. The Company could be held contingently liable to the customer for the transfers of property, disbursements of proceeds and the returns on such proceeds.

At September 30, 2016 and December 31, 2015, the Company was contingently liable for guarantees of indebtedness owed by affiliates and third parties to banks and others totaling \$7.4 million and \$8.2 million, respectively. The

guarantee arrangements relate to promissory notes and other contracts that contingently require the Company to make payments to the guaranteed party upon the failure of debtors to make scheduled payments according to the terms of the notes and contracts. The Company's maximum potential obligation under these guarantees totaled \$7.4 million and \$8.2 million at September 30, 2016 and December 31, 2015, respectively, and is limited in duration to the terms of the underlying indebtedness. The Company has not incurred any costs as a result of these guarantees and has not recorded a liability on its condensed consolidated balance sheets related to these guarantees at September 30, 2016 and December 31, 2015.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The Company's primary exposure to market risk relates to interest rate risk associated with certain financial instruments. Although the Company monitors its risk associated with fluctuations in interest rates, it does not currently use derivative financial instruments on any significant scale to hedge these risks.

There have been no material changes in the Company's market risks since the filing of its Annual Report on Form 10-K for the year ended December 31, 2015.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

The Company's chief executive officer and chief financial officer have concluded that, as of September 30, 2016, the end of the quarterly period covered by this Quarterly Report on Form 10-Q, the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended, were effective, based on the evaluation of these controls and procedures required by Rule 13a-15(b) thereunder.

Changes in Internal Control Over Financial Reporting

There was no change in the Company's internal control over financial reporting during the quarter ended September 30, 2016, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings.

The Company and its subsidiaries are parties to a number of non-ordinary course lawsuits. These lawsuits frequently are similar in nature to other lawsuits pending against the Company's competitors.

For those non-ordinary course lawsuits where the Company has determined that a loss is both probable and reasonably estimable, a liability representing the best estimate of the Company's financial exposure based on known facts has been recorded. Actual losses may materially differ from the amounts recorded.

For a substantial majority of these lawsuits, however, it is not possible to assess the probability of loss. Most of these lawsuits are putative class actions which require a plaintiff to satisfy a number of procedural requirements before proceeding to trial. These requirements include, among others, demonstration to a court that the law proscribes in some manner the Company's activities, the making of factual allegations sufficient to suggest that the Company's activities exceeded the limits of the law and a determination by the court—known as class certification—that the law permits a group of individuals to pursue the case together as a class. In certain instances the Company may also be able to compel the plaintiff to arbitrate its claim on an individual basis. If these procedural requirements are not met, either the lawsuit cannot proceed or, as is the case with class certification or compelled arbitration, the plaintiffs lose the financial incentive to proceed with the case (or the amount at issue effectively becomes de minimis). Frequently, a court's determination as to these procedural requirements is subject to appeal to a higher court. As a result of, among other factors, ambiguities and inconsistencies in the myriad laws applicable to the Company's business and the uniqueness of the factual issues presented in any given lawsuit, the Company often cannot determine the probability of loss until a court has finally determined that a plaintiff has satisfied applicable procedural requirements.

Furthermore, because most of these lawsuits are putative class actions, it is often impossible to estimate the possible loss or a range of loss amounts, even where the Company has determined that a loss is reasonably possible. Generally class actions involve a large number of people and the effort to determine which people satisfy the requirements to become plaintiffs—or class members—is often time consuming and burdensome. Moreover, these lawsuits raise complex factual issues which result in uncertainty as to their outcome and, ultimately, make it difficult for the Company to estimate the amount of damages which a plaintiff might successfully prove. In addition, many of the Company's businesses are regulated by various federal, state, local and foreign governmental agencies and are subject to numerous statutory guidelines. These regulations and statutory guidelines often are complex, inconsistent or ambiguous, which results in additional uncertainty as to the outcome of a given lawsuit—including the amount of damages a plaintiff might be afforded—or makes it difficult to analogize experience in one case or jurisdiction to another case or jurisdiction.

Most of the non-ordinary course lawsuits to which the Company and its subsidiaries are parties challenge practices in the Company's title insurance business, though a limited number of cases also pertain to the Company's other businesses. These lawsuits include, among others, cases alleging, among other assertions, that the Company, one of its subsidiaries and/or one of its agents:

- charged an improper rate for title insurance in a refinance transaction, including

- *Lewis v. First American Title Insurance Company*, filed on November 28, 2006 and pending in the United States District Court for the District of Idaho.

A court has granted class certification in *Lewis*. For the reasons stated above, the Company has been unable to assess the probability of loss or estimate the possible loss or the range of loss.

- purchased minority interests in title insurance agents as an inducement to refer title insurance underwriting business to the Company or gave items of value to title insurance agents and others for referrals of business in violation of the Real Estate Settlement Procedures Act, including

- *Edwards v. First American Financial Corporation*, filed on June 12, 2007 and pending in the United States District Court for the Central District of California.

In *Edwards* the court has issued final approval of a settlement. The anticipated loss, for which a liability has been previously recorded, is not material to the condensed consolidated financial statements as a whole.

- misclassified certain employees, including

- *Cruz v. First American Financial Corporation, et al.*, filed on November 25, 2015 and pending in the Superior Court of the State of California, County of Orange,

- *Sager v. Interthinx, Inc.*, filed on January 23, 2015 and pending in the Superior Court of the State of California, County of Los Angeles, and

- *Weber v. Interthinx, Inc., et al.*, filed on April 17, 2015 and pending in the United States District Court for the Eastern District of Missouri.

These lawsuits are putative class actions for which a class has not been certified. For the reasons described above, as well as the applicability of certain indemnification rights the Company may have, the Company has not yet been able to assess the probability of loss or estimate the possible loss or the range of loss or, where the Company has been able to make an estimate, the Company believes the amount is not material to the condensed consolidated financial statements as a whole.

- overcharged or improperly charged fees for products and services, conspired to fix prices, participated in the conveyance of illusory property interests, denied home warranty claims, and gave items of value to builders, brokers and others as inducements to refer business in violation of certain laws, such as consumer protection laws and laws generally prohibiting unfair business practices, and certain obligations, including

- *Chassen v. First American Financial Corporation, et al.*, filed on January 22, 2009 and pending in the United States District Court of New Jersey,

- *Downing v. First American Title Insurance Company, et al.*, filed on July 26, 2016 and pending in the Northern District of Georgia,

- *Kaufman v. First American Financial Corporation, et al.*, filed on December 21, 2007 and pending in the Superior Court of the State of California, County of Los Angeles,

- *Kirk v. First American Financial Corporation, et al.*, filed on June 15, 2006 and pending in the Superior Court of the State of California, County of Los Angeles,

- *Lennen v. First American Financial Corporation, et al.*, filed on May 19, 2016 and pending in the United States District court for the Middle District of Florida,

- *McCormick v. First American Real Estate Services, Inc., et al.*, filed on December 31, 2015 and pending in the Superior Court of the State of California, County of Orange,

-

Sjobring v. First American Financial Corporation, et al., filed on February 25, 2005 and pending in the Superior Court of the State of California, County of Los Angeles,

47

---



• *Wilmot v. First American Financial Corporation, et al.*, filed on April 20, 2007 and pending in the Superior Court of the State of California, County of Los Angeles, and

• *In re First American Home Buyers Protection Corporation*, consolidated on October 9, 2014 and pending in the United States District Court for the Southern District of California.

All of these lawsuits, except *Kaufman and Kirk*, are putative class actions for which a class has not been certified. In *Kaufman* a class was certified but that certification was subsequently vacated. A trial of the *Kirk* matter has concluded and the judgment has been affirmed on appeal. For the reasons described above, the Company has not yet been able to assess the probability of loss or estimate the possible loss or the range of loss or, where the Company has been able to make an estimate, the Company believes the amount is not material to the condensed consolidated financial statements as a whole.

While some of the lawsuits described above may be material to the Company's operating results in any particular period if an unfavorable outcome results, the Company does not believe that any of these lawsuits will have a material adverse effect on the Company's overall financial condition or liquidity.

The Company also is a party to non-ordinary course lawsuits other than those described above. With respect to these lawsuits, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.

The Company's title insurance, property and casualty insurance, home warranty, banking, thrift, trust and investment advisory businesses are regulated by various federal, state and local governmental agencies. Many of the Company's other businesses operate within statutory guidelines. Consequently, the Company may from time to time be subject to examination or investigation by such governmental agencies. Currently, governmental agencies are examining or investigating certain of the Company's operations. These exams or investigations include inquiries into, among other matters, pricing and rate setting practices in the title insurance industry, competition in the title insurance industry, real estate settlement service customer acquisition and retention practices and agency relationships. With respect to matters where the Company has determined that a loss is both probable and reasonably estimable, the Company has recorded a liability representing its best estimate of the financial exposure based on known facts. While the ultimate disposition of each such exam or investigation is not yet determinable, the Company does not believe that individually or in the aggregate they will have a material adverse effect on the Company's financial condition, results of operations or cash flows. These exams or investigations could, however, result in changes to the Company's business practices which could ultimately have a material adverse impact on the Company's financial condition, results of operations or cash flows.

The Company and its subsidiaries also are involved in numerous ongoing routine legal and regulatory proceedings related to their operations. With respect to each of these proceedings, the Company has determined either that a loss is not reasonably possible or that the estimated loss or range of loss, if any, is not material to the condensed consolidated financial statements as a whole.

#### Item 1A. Risk Factors.

You should carefully consider each of the following risk factors and the other information contained in this Quarterly Report on Form 10-Q. The Company faces risks other than those listed here, including those that are unknown to the Company and others of which the Company may be aware but, at present, considers immaterial. Because of the following factors, as well as other variables affecting the Company's operating results, past financial performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

1. Conditions in the real estate market generally impact the demand for a substantial portion of the Company's products and services and the Company's claims experience

Demand for a substantial portion of the Company's products and services generally decreases as the number of real estate transactions in which its products and services are purchased decreases. The number of real estate transactions in which the Company's products and services are purchased decreases in the following situations:

- when mortgage interest rates are high or rising;
- when the availability of credit, including commercial and residential mortgage funding, is limited; and
- when real estate values are declining.

These circumstances, particularly declining real estate values and the increase in foreclosures that often results therefrom, also tend to adversely impact the Company's title claims experience.

2. Unfavorable economic conditions may have a material adverse effect on the Company

Historically, uncertainty and negative trends in general economic conditions in the United States and abroad, including significant tightening of credit markets and a general decline in the value of real property, have created a difficult operating environment for the Company's businesses and other companies in its industries. In addition, the Company holds investments in entities, such as title agencies and settlement service providers, as well as securities in its investment portfolio, which may be negatively impacted by these conditions. The Company also owns a federal savings bank into which it deposits some of its own funds and some funds held in trust for third parties. This bank invests those funds and any realized losses incurred will be reflected in the Company's consolidated results. The likelihood of such losses, which generally would not occur if the Company were to deposit these funds in an unaffiliated entity, increases when economic conditions are unfavorable. Depending upon the ultimate severity and duration of any economic downturn, the resulting effects on the Company could be materially adverse, including a significant reduction in revenues, earnings and cash flows, challenges to the Company's ability to satisfy covenants or otherwise meet its obligations under debt facilities, difficulties in obtaining access to capital, challenges to the Company's ability to pay dividends at currently anticipated levels, deterioration in the value of its investments and increased credit risk from customers and others with obligations to the Company.

3. Unfavorable economic or other conditions could cause the Company to write off a portion of its goodwill and other intangible assets

The Company performs an impairment test of the carrying value of goodwill and other indefinite-lived intangible assets annually in the fourth quarter, or sooner if circumstances indicate a possible impairment. Finite-lived intangible assets are subject to impairment tests on a periodic basis. Factors that may be considered in connection with this review include, without limitation, underperformance relative to historical or projected future operating results, reductions in the Company's stock price and market capitalization, increased cost of capital and negative macroeconomic, industry and company-specific trends. These and other factors could lead to a conclusion that goodwill or other intangible assets are no longer fully recoverable, in which case the Company would be required to write off the portion believed to be unrecoverable. Total goodwill and other intangible assets reflected on the Company's condensed consolidated balance sheet as of September 30, 2016 are \$1.1 billion. Any substantial goodwill and other intangible asset impairments that may be required could have a material adverse effect on the Company's results of operations and financial condition.

4. Failures at financial institutions at which the Company deposits funds could adversely affect the Company

The Company deposits substantial funds in financial institutions. These funds include amounts owned by third parties, such as escrow deposits. Should one or more of the financial institutions at which deposits are maintained fail, there is no guarantee that the Company would recover the funds deposited, whether through Federal Deposit Insurance Corporation coverage or otherwise. In the event of any such failure, the Company also could be held liable for the funds owned by third parties.

5. Changes in government regulation could prohibit or limit the Company's operations, make it more burdensome to conduct such operations or result in decreased demand for the Company's products and services

Many of the Company's businesses, including its title insurance, property and casualty insurance, home warranty, banking, trust and investment businesses, are regulated by various federal, state, local and foreign governmental agencies. These and other of the Company's businesses also operate within statutory guidelines. The industry in which

the Company operates and the markets into which it sells its products are also regulated and subject to statutory guidelines. Changes in the applicable regulatory environment, statutory guidelines or interpretations of existing regulations or statutes, enhanced governmental oversight or efforts by governmental agencies to cause customers to refrain from using the Company's products or services could prohibit or limit its future operations or make it more burdensome to conduct such operations or result in decreased demand for the Company's products and services. The impact of these changes would be more significant if they involve jurisdictions in which the Company generates a greater portion of its title premiums, such as the states of Arizona, California, Florida, Michigan, New York, Ohio, Pennsylvania and Texas. These changes may compel the Company to reduce its prices, may restrict its ability to implement price increases or acquire assets or businesses, may limit the manner in which the Company conducts its business or otherwise may have a negative impact on its ability to generate revenues, earnings and cash flows.

6. Scrutiny of the Company's businesses and the industries in which it operates by governmental entities and others could adversely affect its operations and financial condition

The real estate settlement services industry, an industry in which the Company generates a substantial portion of its revenue and earnings, is subject to continuous scrutiny by regulators, legislators, the media and plaintiffs' attorneys. Though often directed at the industry generally, these groups may also focus their attention directly on the Company's businesses. In either case, this scrutiny may result in changes which could adversely affect the Company's operations and, therefore, its financial condition and liquidity.

Governmental entities have routinely inquired into certain practices in the real estate settlement services industry to determine whether certain of the Company's businesses or its competitors have violated applicable laws, which include, among others, the insurance codes of the various jurisdictions and the Real Estate Settlement Procedures Act and similar state, federal and foreign laws. Departments of insurance in the various states, federal regulators and applicable regulators in international jurisdictions, either separately or together, also periodically conduct targeted inquiries into the practices of title insurance companies and other settlement services providers in their respective jurisdictions.

Further, from time to time plaintiffs' lawyers may target the Company and other members of the Company's industry with lawsuits claiming legal violations or other wrongful conduct. These lawsuits may involve large groups of plaintiffs and claims for substantial damages. Any of these types of inquiries or proceedings may result in a finding of a violation of the law or other wrongful conduct and may result in the payment of fines or damages or the imposition of restrictions on the Company's conduct which could impact its operations and financial condition. Moreover, these laws and standards of conduct often are ambiguous and, thus, it may be difficult to ensure compliance. This ambiguity may force the Company to mitigate its risk by settling claims or by ending practices that generate revenues, earnings and cash flows.

We increasingly utilize social media to communicate with customers, vendors, current and potential employees and other individuals interested in our Company. Information delivered via social media can be easily accessed and rapidly disseminated, and the use of social media by us and other parties could result in reputational harm, decreased customer loyalty or other issues that could diminish the value of the Company's brand or result in significant liability.

7. The breadth of the Consumer Financial Protection Bureau's rulemaking and supervisory powers may increase our costs and require changes in our business

The Consumer Financial Protection Bureau ("CFPB") has broad authority to regulate, among other areas, the mortgage and real estate markets, including our domestic subsidiaries, in matters which impact consumers. This authority includes the enforcement of federal consumer financial laws, including the Real Estate Settlement Procedures Act. The CFPB has been actively utilizing its supervisory powers by bringing enforcement actions against various participants in the mortgage and settlement industries. It has also actively proposed and implemented regulations pertaining to the mortgage and settlement industries, including the TILA-RESPA integrated mortgage disclosure rule, commonly known as the Know Before You Owe rule. The full manner in which the CFPB will utilize its rulemaking and supervisory powers in the future is not known. Regulations issued by the CFPB, or the manner in which it interprets and enforces existing consumer protection laws, have impacted and could continue to impact the way in which we conduct our businesses and the profitability of those businesses.

8. Regulation of title insurance rates could adversely affect the Company's results of operations

Title insurance rates are subject to extensive regulation, which varies from state to state. In many states the approval of the applicable state insurance regulator is required prior to implementing a rate change. This regulation could

hinder the Company's ability to promptly adapt to changing market dynamics through price adjustments, which could adversely affect its results of operations, particularly in a rapidly declining market.

9. Reform of government-sponsored enterprises could negatively impact the Company

Historically, a substantial proportion of home loans originated in the United States were sold to and, generally, resold in a securitized form by, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). As a condition to the purchase of a home loan, Fannie Mae and Freddie Mac generally required the purchase of title insurance for their benefit and, as applicable, the benefit of the holders of home loans they may have securitized. The federal government currently is considering various alternatives to reform Fannie Mae and Freddie Mac. The role, if any, that these enterprises or other enterprises fulfilling a similar function will play in the mortgage process following the adoption of any reforms is not currently known. The timing of the adoption and, thereafter, the implementation of the reforms is similarly unknown. Due to the significance of the role of these enterprises, the mortgage process itself may substantially change as a result of these reforms and related discussions. It is possible that these entities, as reformed, or the successors to these entities may require changes to the way title insurance is priced or delivered, changes to standard policy terms or other changes which may make the title insurance business less profitable. These reforms may also alter the home loan market, such as by causing higher mortgage interest rates due to decreased governmental support of mortgage-backed securities. These consequences could be materially adverse to the Company and its financial condition.

10. The Company may find it difficult to acquire necessary data

Certain data used and supplied by the Company are subject to regulation by various federal, state and local regulatory authorities. Compliance with existing federal, state and local laws and regulations with respect to such data has not had a material adverse effect on the Company's results of operations, financial condition or liquidity to date. Nonetheless, federal, state and local laws and regulations in the United States designed to protect the public from the misuse of personal information in the marketplace and adverse publicity or potential litigation concerning the commercial use of such information may affect the Company's operations and could result in substantial regulatory compliance expense, litigation expense and a loss of revenue. The suppliers of data to the Company face similar burdens. As a result of these and other factors, the Company may find it financially burdensome to acquire necessary data.

11. Changes in the Company's relationships with large mortgage lenders or government-sponsored enterprises could adversely affect the Company

The mortgage markets in the United States and Canada are concentrated. Due to the consolidated nature of the industry, the Company derives a significant percentage of its revenues from a relatively small base of lenders, and their borrowers, which enhances the negotiating power of these lenders with respect to the pricing and the terms on which they purchase the Company's products and other matters. Similarly, government-sponsored enterprises, because of their significant role in the mortgage process, have significant influence over the Company and other service providers. These circumstances could adversely affect the Company's revenues and profitability. Changes in the Company's relationship with any of these lenders or government-sponsored enterprises, the loss of all or a portion of the business the Company derives from these parties or any refusal of these parties to accept the Company's products and services could have a material adverse effect on the Company.

12. A downgrade by ratings agencies, reductions in statutory capital and surplus maintained by the Company's title insurance underwriters or a deterioration in other measures of financial strength may negatively affect the Company's results of operations and competitive position

Certain of the Company's customers use measurements of the financial strength of the Company's title insurance underwriters, including, among others, ratings provided by ratings agencies and levels of statutory capital and surplus maintained by those underwriters, in determining the amount of a policy they will accept and the amount of

reinsurance required. Each of the major ratings agencies currently rates the Company's title insurance operations. The Company's principal title insurance underwriter's financial strength ratings are "A3" by Moody's Investor Services, Inc., "A" by Fitch Ratings, Inc., "A-" by Standard & Poor's Ratings Services and "A" by A.M. Best Company, Inc. These ratings provide the agencies' perspectives on the financial strength, operating performance and cash generating ability of those operations. These agencies continually review these ratings and the ratings are subject to change. Statutory capital and surplus, or the amount by which statutory assets exceed statutory liabilities, is also a measure of financial strength. The Company's principal title insurance underwriter maintained \$1.1 billion of total statutory capital and surplus as of December 31, 2015. Accordingly, if the ratings or statutory capital and surplus of these title insurance underwriters are reduced from their current levels, or if there is a deterioration in other measures of financial strength, the Company's results of operations, competitive position and liquidity could be adversely affected.



13. The Company's investment portfolio is subject to certain risks and could experience losses

The Company maintains a substantial investment portfolio, primarily consisting of fixed income securities (including mortgage-backed securities). The investment portfolio also includes money-market and other short-term investments, as well as preferred and common stock. Securities in the Company's investment portfolio are subject to certain economic and financial market risks, such as credit risk, interest rate (including call, prepayment and extension) risk and/or liquidity risk. The risk of loss associated with the portfolio is increased during periods of instability in credit markets and economic conditions. If the carrying value of the investments exceeds the fair value, and the decline in fair value is deemed to be other-than-temporary, the Company will be required to write down the value of the investments, which could have a material adverse effect on the Company's results of operations, statutory surplus and financial condition.

14. Actual claims experience could materially vary from the expected claims experience reflected in the Company's reserve for incurred but not reported claims

The Company maintains a reserve for incurred but not reported ("IBNR") claims pertaining to its title, escrow and other insurance and guarantee products. The majority of this reserve pertains to title insurance policies, which are long-duration contracts with the majority of the claims reported within the first few years following the issuance of the policy. Generally, 70% to 80% of claim amounts become known in the first six years of the policy life, and the majority of IBNR reserves relate to the six most recent policy years. Changes in expected ultimate losses and corresponding loss rates for recent policy years are considered likely and could result in a material adjustment to the IBNR reserves. Based on historical experience, management believes a 50 basis point change to the loss rates for recent policy years, positive or negative, is reasonably likely given the long duration nature of a title insurance policy. For example, if the expected ultimate losses for each of the last six policy years increased or decreased by 50 basis points, the resulting impact on the Company's IBNR reserve would be an increase or decrease, as the case may be, of \$108.2 million. A material change in expected ultimate losses and corresponding loss rates for older policy years is also possible, particularly for policy years with loss ratios exceeding historical norms. The estimates made by management in determining the appropriate level of IBNR reserves could ultimately prove to be materially different from actual claims experience.

15. The issuance of the Company's title insurance policies and related activities by title agents, which operate with substantial independence from the Company, could adversely affect the Company

The Company's title insurance subsidiaries issue a significant portion of their policies through title agents that operate with a substantial degree of independence from the Company. While these title agents are subject to certain contractual limitations that are designed to limit the Company's risk with respect to their activities, there is no guarantee that the agents will fulfill their contractual obligations to the Company. In addition, regulators are increasingly seeking to hold the Company responsible for the actions of these title agents and, under certain circumstances, the Company may be held liable directly to third parties for actions (including defalcations) or omissions of these agents. Recent case law in certain states also suggests that the Company is liable for the actions or omissions of its agents in those states, regardless of contractual limitations. As a result, the Company's use of title agents could result in increased claims on the Company's policies issued through agents and an increase in other costs and expenses.

16. The Company's risk mitigation efforts may prove inadequate

The Company assumes risks in the ordinary course of its business, including through the issuance of title insurance policies and the provision of other products and services. The Company mitigates these risks through a number of different means, including the implementation of underwriting policies and procedures and other mechanisms for

assessing risk. However, underwriting of title insurance policies and other risk-assumption decisions frequently involve a substantial degree of individual judgment. The Company's risk mitigation efforts or the reliability of any necessary judgment may prove inadequate, especially in situations where the Company or individuals involved in risk taking decisions are encouraged by customers or others, or because of competitive pressures, to assume risks or to expeditiously make risk determinations. This circumstance could have an adverse effect on the Company's results of operations, financial condition and liquidity.

17. Systems damage, failures, interruptions and intrusions, and unauthorized data disclosures may disrupt the Company's business, harm the Company's reputation, result in material claims for damages or otherwise adversely affect the Company

The Company uses computer systems to receive, process, store and transmit business information, including highly sensitive non-public personal information as well as data from suppliers and other information upon which its business relies. It also uses these systems to manage substantial cash, investment assets, bank deposits, trust assets and escrow account balances on behalf of the Company and its customers, among other activities. Many of the Company's products, services and solutions involving the use of real property related data are fully reliant on its systems and are only available electronically. Accordingly, for a variety of reasons, the integrity of the Company's computer systems and the protection of the information that resides on those systems are critically important to its successful operation. The Company's core computer systems are primarily located in two data centers. The Company manages its primary data center and the secondary data center is maintained and managed by a third party.

The Company's computer systems and systems used by its agents, suppliers and customers have been subject to, and are likely to continue to be the target of, computer viruses, cyber attacks, phishing attacks and other malicious attacks. These attacks have increased in frequency and sophistication in recent years, and could expose the Company to system-related damage, failures, interruptions, and other negative events. Further, certain other potential causes of system damage or other negative system-related events are wholly or partially beyond the Company's control, such as natural disasters, vendor failures to satisfy service level requirements and power or telecommunications failures. These incidents, regardless of their underlying causes, could disrupt the Company's business and could also result in the loss or unauthorized release, gathering, monitoring or destruction of confidential, proprietary and other information pertaining to the Company, its customers, employees, agents or suppliers.

Certain laws and contracts the Company has entered into require it to notify various parties, including consumers or customers, in the event of certain actual or potential data breaches or systems failures. These notifications can result, among other things, in the loss of customers, lawsuits, adverse publicity, diversion of management's time and energy, the attention of regulatory authorities, fines and disruptions in sales. Further, the Company's financial institution customers have obligations to safeguard their computer systems and sensitive information and it may be bound contractually and/or by regulation to comply with the same requirements. If the Company fails to comply with applicable regulations and contractual requirements, it could be exposed to lawsuits, governmental proceedings or the imposition of fines, among other consequences.

Accordingly, any inability to prevent or adequately respond to the issues described above could disrupt the Company's business, inhibit its ability to retain existing customers or attract new customers and/or result in financial losses, litigation, increased costs or other adverse consequences which could be material to the Company.

18. Errors and fraud involving the transfer of funds may result in material financial losses or harm the Company's reputation

The Company relies on its systems, employees and domestic and international banks to transfer funds. These transfers are susceptible to user input error, fraud, system interruptions, incorrect processing and similar errors that could result in lost funds or delayed transactions. The Company's email and computer systems and systems used by its agents, customers and other parties involved in a transaction have been subject to, and are likely to continue to be the target of, fraudulent attacks, including attempts to cause the Company or its agents to improperly transfer funds. These attacks have increased in frequency and sophistication in recent years. Funds transferred to a fraudulent recipient are often not recoverable. In certain instances the Company may be liable for those unrecovered funds. The controls and procedures used by the Company to prevent transfer errors and fraud may prove inadequate, resulting in financial losses, reputational harm, loss of customers or other adverse consequences which could be material to the Company.

19. The Company may not be able to realize the benefits of its offshore operations

The Company utilizes lower cost labor in foreign countries, such as India and the Philippines, among others. These countries are subject to relatively high degrees of political and social instability and may lack the infrastructure to withstand natural disasters. Such disruptions could decrease efficiency and increase the Company's costs in these countries. Weakness of the United States dollar in relation to the currencies used in these foreign countries may also reduce the savings achievable through this strategy. Furthermore, the practice of utilizing labor based in foreign countries is subject to heightened scrutiny in the United States and, as a result, some of the Company's customers may require it to use labor based in the United States. Laws or regulations that require the Company to use labor based in the United States or effectively increase the cost of the Company's foreign labor also could be enacted. The Company may not be able to pass on these increased costs to its customers.

20. Acquisitions may have an adverse effect on our business

The Company has in the past acquired, and is expected to acquire in the future, other businesses. When businesses are acquired, the Company may not be able to integrate or manage these businesses in such a manner as to realize the anticipated synergies or otherwise produce returns that justify the investment. Acquired businesses may subject the Company to increased regulatory or compliance requirements. The Company may not be able to successfully retain employees of acquired businesses or integrate them, and could lose customers, suppliers or other partners as a result of the acquisitions. For these and other reasons, including changes in market conditions, the projections used to value the acquired businesses may prove inaccurate. In addition, the Company might incur unanticipated liabilities from acquisitions. These and other factors related to acquisitions could have a material adverse effect on the Company's results of operations, financial condition and liquidity. The Company's management also will continue to be required to dedicate substantial time and effort to the integration of its acquisitions. These efforts could divert management's focus and resources from other strategic opportunities and operational matters.

21. As a holding company, the Company depends on distributions from its subsidiaries, and if distributions from its subsidiaries are materially impaired, the Company's ability to declare and pay dividends may be adversely affected; in addition, insurance and other regulations limit the amount of dividends, loans and advances available from the Company's insurance subsidiaries

The Company is a holding company whose primary assets are investments in its operating subsidiaries. The Company's ability to pay dividends is dependent on the ability of its subsidiaries to pay dividends or repay funds. If the Company's operating subsidiaries are not able to pay dividends or repay funds, the Company may not be able to fulfill parent company obligations and/or declare and pay dividends to its stockholders. Moreover, pursuant to insurance and other regulations under which the Company's insurance subsidiaries operate, the amount of dividends, loans and advances available is limited. As of September 30, 2016, under such regulations, the maximum amount of dividends, loans and advances available in 2016 from these insurance subsidiaries, without prior approval from applicable regulators, was \$549.1 million.

22. Certain provisions of the Company's bylaws and certificate of incorporation may reduce the likelihood of any unsolicited acquisition proposal or potential change of control that the Company's stockholders might consider favorable

The Company's bylaws and certificate of incorporation contain provisions that could be considered "anti-takeover" provisions because they make it harder for a third-party to acquire the Company without the consent of the Company's incumbent board of directors. Under these provisions:

- election of the Company's board of directors is staggered such that only one-third of the directors are elected by the stockholders each year and the directors serve three year terms prior to reelection;
- stockholders may not remove directors without cause, change the size of the board of directors or, except as may be provided for in the terms of preferred stock the Company issues in the future, fill vacancies on the board of directors;
- stockholders may act only at stockholder meetings and not by written consent;
- stockholders must comply with advance notice provisions for nominating directors or presenting other proposals at stockholder meetings; and
- the Company's board of directors may without stockholder approval issue preferred shares and determine their rights and terms, including voting rights, or adopt a stockholder rights plan.

While the Company believes that they are appropriate, these provisions, which may only be amended by the affirmative vote of the holders of approximately 67% of the Company's issued voting shares, could have the effect of discouraging an unsolicited acquisition proposal or delaying, deferring or preventing a change of control transaction that might involve a premium price or otherwise be considered favorably by the Company's stockholders.

Item 6. Exhibits.

See Exhibit Index. (Each management contract or compensatory plan or arrangement in which any director or named executive officer of First American Financial Corporation, as defined by Item 402(a)(3) of Regulation S-K (17 C.F.R. §229.402(a)(3)), participates that is included among the exhibits listed on the Exhibit Index is identified on the Exhibit Index by an asterisk (\*).)

SIGNATURES

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

FIRST AMERICAN FINANCIAL CORPORATION

(Registrant)

By /s/ Dennis J. Gilmore  
Dennis J. Gilmore  
Chief Executive Officer

(Principal Executive Officer)

By /s/ Mark E. Seaton  
Mark E. Seaton  
Chief Financial Officer

(Principal Financial Officer)

Date: October 20, 2016

EXHIBIT INDEX

Exhibit No.	Description	Location
3.1	Amended and Restated Certificate of Incorporation of First American Financial Corporation dated May 28, 2010.	Incorporated by reference herein to Exhibit 3.1 to the Current Report on Form 8-K dated June 1, 2010.
3.2	Amended and Restated Bylaws of First American Financial Corporation, effective as of February 20, 2015.	Incorporated by reference herein to Exhibit 3.2 to the Annual Report on Form 10-K for the year ended December 31, 2014.
31(a)	Certification by Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.	Attached.
31(b)	Certification by Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.	Attached.
32(a)	Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350.	Attached.
32(b)	Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.	Attached.
101.INS	XBRL Instance Document.	Attached.
101.SCH	XBRL Taxonomy Extension Schema Document.	Attached.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	Attached.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	Attached.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	Attached.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	Attached.