First American Financial Corp
Form 10-Q
October 23, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

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

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 x 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 x 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 x		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 x

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

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 1 No 1

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 20, 2014, there were 107,264,707 shares of common stock outstanding.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

INFORMATION INCLUDED IN REPORT

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

CERTAIN STATEMENTS IN THIS QUARTERLY REPORT ON FORM 10-Q, INCLUDING BUT NOT LIMITED TO THOSE RELATING TO:

- THE EFFECT OF PENDING ACCOUNTING PRONOUNCEMENTS ON THE COMPANY'S FINANCIAL STATEMENTS;
- THE HOLDING OF AND EXPECTED CASH FLOWS FROM DEBT SECURITIES AND ASSUMPTIONS RELATING THERETO;
- EXPECTED PENSION PLAN AND SUPPLEMENTAL BENEFIT PLAN CONTRIBUTIONS AND RETURNS;
- THE EFFECT OF LAWSUITS, REGULATORY EXAMINATIONS AND INVESTIGATIONS AND OTHER LEGAL PROCEEDINGS ON THE COMPANY'S FINANCIAL CONDITION, RESULTS OF OPERATIONS OR CASH FLOWS;
- FUTURE ACTIONS TO BE TAKEN IN CONNECTION WITH THE COMPANY'S REVIEW OF ITS AGENCY RELATIONSHIPS;
- FUTURE PAYMENT OF DIVIDENDS;
- THE SUFFICIENCY OF THE COMPANY'S RESOURCES TO SATISFY OPERATIONAL CASH REQUIREMENTS;
- THE LIKELIHOOD OF CHANGES IN EXPECTED ULTIMATE LOSSES AND CORRESPONDING LOSS RATES AND CLAIM RESERVES;
- ANTICIPATED RECOVERIES IN CONNECTION WITH A LARGE COMMERCIAL CLAIM;
- FUTURE ACQUISITIONS;
- THE IMPACT OF THE REDOMESTICATION OF THE COMPANY'S PRINCIPAL TITLE INSURANCE SUBSIDIARY FROM CALIFORNIA TO NEBRASKA; AND
- CANADIAN EXCISE TAXES FOR SERVICES PROVIDED TO LENDERS,

ARE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. THESE FORWARD-LOOKING STATEMENTS MAY CONTAIN THE WORDS "BELIEVE," "ANTICIPATE," "EXPECT," "PLAN," "PREDICT," "ESTIMATE," "PROJECT," "WILL BE," "WILL CONT "WILL LIKELY RESULT," OR OTHER SIMILAR WORDS AND PHRASES.

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:

- 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;
- EXPENSES OF AND FUNDING OBLIGATIONS TO THE PENSION PLAN;

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- 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 INTERRUPTIONS AND INTRUSIONS, WIRE TRANSFER ERRORS OR UNAUTHORIZED DATA DISCLOSURES;
- INABILITY TO REALIZE THE BENEFITS OF THE COMPANY'S OFFSHORE STRATEGY;
- INABILITY OF THE COMPANY'S SUBSIDIARIES TO PAY DIVIDENDS OR REPAY FUNDS;
- CHALLENGES AND ADVERSE EFFECTS ARISING FROM ACQUISITIONS; AND
- OTHER FACTORS DESCRIBED IN PART II, ITEM 1A OF THIS QUARTERLY REPORT ON FORM 10-Q.

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, 2014	December 31, 2013
Assets		
Cash and cash equivalents	$1,203,873	$ 834,837
Accounts and accrued income receivable, net	283,385	236,895
Income taxes receivable	—	37,632
Investments:		
Deposits with banks	20,515	23,492
Debt securities, includes pledged securities of $125,942 and $123,956	3,100,884	2,819,817
Equity securities	393,741	358,043
Other long-term investments	177,639	183,976
	3,692,779	3,385,328
Loans receivable, net	53,753	73,755
Property and equipment, net	387,832	361,348
Title plants and other indexes	527,334	523,879
Deferred income taxes	27,478	27,478
Goodwill	955,819	846,026
Other intangible assets, net	61,070	46,347
Other assets	194,892	185,658
	$7,388,215	$ 6,559,183
Liabilities and Equity		
Deposits	$2,299,305	$ 1,692,932
Accounts payable and accrued liabilities	701,772	795,812
Deferred revenue	201,381	192,184
Reserve for known and incurred but not reported claims	1,011,344	1,018,365
Income taxes payable	45,302	—
Deferred income taxes	97,174	93,362
Notes and contracts payable	450,928	310,285
	4,807,206	4,102,940
Commitments and contingencies (Note 16)		
Stockholders' equity:		
Preferred stock, $0.00001 par value; Authorized—500 shares;	—	—

Outstanding—none		
Common stock, $0.00001 par value; Authorized—300,000 shares;		
Outstanding—107,253 shares and 105,900 shares	1	1
Additional paid-in capital	2,102,283	2,077,828
Retained earnings	608,146	520,764
Accumulated other comprehensive loss	(132,345)	(145,544)
Total stockholders' equity	2,578,085	2,453,049
Noncontrolling interests	2,924	3,194
Total equity	2,581,009	2,456,243
	$7,388,215	$ 6,559,183

See notes to condensed consolidated financial statements.

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FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Income

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues				
Direct premiums and escrow fees	$ 564,396	$ 573,116	$ 1,529,391	$ 1,644,172
Agent premiums	496,887	549,052	1,341,020	1,530,247
Information and other	161,227	159,775	464,572	483,430
Investment income	22,828	26,001	64,254	71,544
Net realized investment gains (losses)	14,392	(6,966)	24,294	6,812
Net other-than-temporary impairment ("OTTI") losses recognized in earnings:				
Total OTTI losses on debt securities	—	—	(167)	—
Portion of OTTI losses on debt securities recognized in other comprehensive loss	—	—	(866)	—
	—	—	(1,033)	—
	1,259,730	1,300,978	3,422,498	3,736,205
Expenses				
Personnel costs	365,304	377,872	1,045,955	1,087,139
Premiums retained by agents	395,324	440,453	1,070,260	1,224,020
Other operating expenses	219,536	222,297	622,024	660,408
Provision for policy losses and other claims	119,390	114,952	337,739	429,744
Depreciation and amortization	24,127	18,554	63,879	55,141
Premium taxes	15,427	15,771	41,971	42,683
Interest	4,670	4,034	13,007	11,209
	1,143,778	1,193,933	3,194,835	3,510,344
Income before income taxes	115,952	107,045	227,663	225,861
Income taxes	35,015	42,950	74,186	90,586
Net income	80,937	64,095	153,477	135,275
Less: Net income attributable to noncontrolling interests	232	205	454	535
Net income attributable to the Company	$ 80,705	$ 63,890	$ 153,023	$ 134,740
Net income per share attributable to the Company's stockholders (Note 10):				
Basic	$ 0.75	$ 0.60	$ 1.43	$ 1.25
Diluted	$ 0.74	$ 0.59	$ 1.41	$ 1.23
Cash dividends declared per share	$ 0.24	$ 0.12	$ 0.60	$ 0.36
Weighted-average common shares outstanding (Note 10):				
Basic	107,136	106,437	106,727	107,400

Diluted	108,863	108,437	108,546	109,490

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Comprehensive Income

(in thousands)

(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$ 80,937	$ 64,095	$ 153,477	$ 135,275
Other comprehensive income, net of tax:				
Unrealized (loss) gain on securities	(14,886)	5,839	10,918	(34,906)
Unrealized gain on securities for which credit losses have been recognized in earnings	151	400	586	420
Foreign currency translation adjustment	(12,557)	8,968	(6,985)	(7,648)
Pension benefit adjustment	907	4,121	8,690	12,408
Total other comprehensive (loss) income, net of tax	(26,385)	19,328	13,209	(29,726)
Comprehensive income	54,552	83,423	166,686	105,549
Less: Comprehensive income attributable to noncontrolling interests	235	207	464	530
Comprehensive income attributable to the Company	$ 54,317	$ 83,216	$ 166,222	$ 105,019

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	For the Nine Months Ended September 30, 2014	2013
Cash flows from operating activities:		
Net income	$153,477	$135,275
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for policy losses and other claims	337,739	429,744
Depreciation and amortization	63,879	55,141
Amortization of premiums and accretion of discounts on securities, net	17,984	18,757
Excess tax benefits from share-based compensation	(6,050)	(5,796)
Share-based compensation	15,962	18,601
Net realized investment gains	(24,294)	(6,812)
Net OTTI losses recognized in earnings	1,033	—
Equity in earnings of affiliates, net	(1,068)	(11,240)
Dividends from equity method investments	4,018	7,072
Changes in assets and liabilities excluding effects of acquisitions and noncash transactions:		
Claims paid, including assets acquired, net of recoveries	(353,048)	(348,058)
Net change in income tax accounts	55,372	2,931
(Increase) decrease in accounts and accrued income receivable	(23,191)	3,977
Decrease in accounts payable and accrued liabilities	(74,407)	(54,982)
Increase in deferred revenue	6,780	15,127
Other, net	(8,015)	(13,904)
Cash provided by operating activities	166,171	245,833
Cash flows from investing activities:		
Net cash effect of acquisitions/dispositions	(162,910)	(650)
Net decrease in deposits with banks	2,888	512
Net decrease in loans receivable	20,002	30,285
Purchases of debt and equity securities	(1,203,474)	(1,227,720)
Proceeds from sales of debt and equity securities	627,174	507,757
Proceeds from maturities of debt securities	276,812	401,941
Net change in other long-term investments	5,093	1,971
Capital expenditures	(63,923)	(61,017)
Proceeds from sale of property and equipment	11,675	5,399
Cash used for investing activities	(486,663)	(341,522)
Cash flows from financing activities:		
Net change in deposits	606,373	313,016
Proceeds from issuance of debt	300,503	249,095

Repayment of debt	(161,878)	(167,036)
Net proceeds (payments) in connection with share-based compensation plans	885	(1,080)
Net activity related to noncontrolling interests	(658)	(1,800)
Excess tax benefits from share-based compensation	6,050	5,796
Purchase of Company shares	—	(64,606)
Cash dividends	(64,159)	(38,629)
Cash provided by financing activities	687,116	294,756
Effect of exchange rate changes on cash	2,412	(2,317)
Net increase in cash and cash equivalents	369,036	196,750
Cash and cash equivalents—Beginning of period	834,837	670,529
Cash and cash equivalents—End of period	$1,203,873	$867,279
Supplemental information:		
Cash paid during the period for:		
Interest	$15,701	$9,428
Premium taxes	$47,729	$45,475
Income taxes, less refunds of $9,843 and $613	$20,510	$87,242

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 stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Total stockholders' equity	Noncontrolling interests	Total
Balance at December 31, 2013	105,900	$1	$2,077,828	$520,764	$(145,544)	$2,453,049	$3,194	$2,456,243
Net income for nine months ended September 30, 2014	—	—	—	153,023	—	153,023	454	153,477
Dividends on common shares	—	—	—	(64,159)	—	(64,159)	—	(64,159)
Shares issued in connection with share-based compensation plans	1,353	—	8,417	(1,482)	—	6,935	—	6,935
Share-based compensation expense	—	—	15,962	—	—	15,962	—	15,962
Net activity related to noncontrolling interests	—	—	76	—	—	76	(734)	(658)
Other comprehensive income (Note 15)	—	—	—	—	13,199	13,199	10	13,209
Balance at September 30, 2014	107,253	$1	$2,102,283	$608,146	$(132,345)	$2,578,085	$2,924	$2,581,009

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, 2013. 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, Revisions and Out-of-Period Adjustments

Certain 2013 amounts have been reclassified to conform to the 2014 presentation.

The condensed consolidated statement of cash flows for the nine months ended September 30, 2013 was revised for an error which resulted in an adjustment between cash and cash equivalents and deposits with banks. The adjustment resulted in a reduction to net increase in deposits with banks of $9.9 million, an increase in cash and cash equivalents—beginning of period of $43.3 million and an increase in cash and cash equivalents—end of period of $33.4 million.

The condensed consolidated balance sheet as of December 31, 2013 was revised for an error which resulted in an adjustment between income taxes receivable and deferred income taxes. The adjustment resulted in an increase to income taxes receivable of $11.1 million, an increase in deferred income tax assets of $27.5 million and an increase in deferred income tax liabilities of $38.6 million.

During the second quarter of 2014, the Company identified and recorded adjustments to correct for certain errors in foreign currency translation and transactions in prior periods. These adjustments resulted in an increase to other operating expenses of $4.3 million.

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

Recently Adopted Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board ("FASB") issued updated guidance intended to eliminate the diversity in practice regarding financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2013, with early adoption permitted. The adoption of the guidance had no impact on the Company's condensed consolidated financial statements.

Pending Accounting Pronouncements

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 Company expects the adoption of this guidance to have no impact on 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 when it is recognized. 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. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption prohibited. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In April 2014, the FASB issued updated guidance which changes the criteria for determining which disposals are required to be presented as discontinued operations and modifies related disclosure requirements. The updated guidance is effective for interim and annual reporting periods beginning after December 31, 2014, with early adoption permitted. The Company expects the adoption of this guidance to have no impact 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 $6.5 billion and $4.7 billion at September 30, 2014 and December 31, 2013, respectively, of which $2.1 billion and $1.6 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 included in the accompanying condensed consolidated balance sheets in cash and cash equivalents and debt and equity securities, with offsetting liabilities included in deposits. The remaining escrow deposits were held at third-party financial institutions.

Trust assets held or managed by First American Trust, FSB totaled $3.0 billion at September 30, 2014 and December 31, 2013. 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, including investment programs, borrowing agreements, and vendor services arrangements with various financial institutions. The effects of 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 $1.4 billion at September 30, 2014 and December 31, 2013, 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 return on the proceeds.

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

Note 3 – Debt and Equity Securities

The amortized cost and estimated fair value of investments in debt securities, all of which are classified as available-for-sale, are as follows:

(in thousands)	Amortized cost	Gross unrealized Gains	Gross unrealized Losses	Estimated fair value	Other-than-temporary impairments in AOCI
September 30, 2014					
U.S. Treasury bonds	$70,909	$732	$(318)	$71,323	$ —
Municipal bonds	534,865	10,668	(897)	544,636	—
Foreign bonds	199,882	1,378	(163)	201,097	—
Governmental agency bonds	204,546	942	(3,261)	202,227	—
Governmental agency mortgage-backed securities	1,522,943	5,287	(13,388)	1,514,842	—
Non-agency mortgage-backed securities (1)	17,246	1,362	(1,057)	17,551	19,877
Corporate debt securities	546,209	6,983	(3,984)	549,208	—
	$3,096,600	$27,352	$(23,068)	$3,100,884	$ 19,877
December 31, 2013					
U.S. Treasury bonds	$66,400	$669	$(685)	$66,384	$ —
Municipal bonds	491,143	5,113	(10,291)	485,965	—
Foreign bonds	221,298	1,836	(626)	222,508	—
Governmental agency bonds	267,713	233	(5,401)	262,545	—
Governmental agency mortgage-backed securities	1,426,489	2,074	(25,254)	1,403,309	—
	19,658	1,167	(1,803)	19,022	20,743

Non-agency mortgage-backed securities (1)					
Corporate debt securities	355,893	7,279	(3,088)	360,084	—
	$2,848,594	$18,371	$(47,148)	$2,819,817	$ 20,743

(1) At September 30, 2014, the $17.2 million amortized cost is net of $1.0 million in other-than-temporary impairments determined to be credit related which have been recognized in earnings for the nine months ended September 30, 2014. At September 30, 2014 and December 31, 2013, the $1.1 million and $1.8 million, respectively, of gross unrealized losses related to securities determined to be other-than-temporarily impaired. The $19.9 million and $20.7 million other-than-temporary impairments recorded in accumulated other comprehensive income (loss) ("AOCI") at September 30, 2014 and December 31, 2013, respectively, which relate to non-agency mortgage-backed securities, represent the amount of other-than-temporary impairment losses recognized in AOCI which were not included in earnings as the losses were not considered to be credit related.

The cost and estimated fair value of investments in equity securities, all of which are classified as available-for-sale, are as follows:

(in thousands)	Cost	Gross unrealized Gains	Gross unrealized Losses	Estimated fair value
September 30, 2014				
Preferred stocks	$15,664	$1,294	$(200)	$16,758
Common stocks	368,594	17,028	(8,639)	376,983
	$384,258	$18,322	$(8,839)	$393,741
December 31, 2013				
Preferred stocks	$9,915	$1,567	$(397)	$11,085
Common stocks	324,184	25,137	(2,363)	346,958
	$334,099	$26,704	$(2,760)	$358,043

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

The Company had the following unrealized gains (losses) as of September 30, 2014 and December 31, 2013:

(in thousands)	As of September 30, 2014	As of December 31, 2013
Debt securities for which an OTTI has been recognized	$ 324	$ (625)
Debt securities—all other	3,960	(28,152)
Equity securities	9,483	23,944
	$ 13,767	$ (4,833)

Sales of debt and equity securities resulted in realized gains of $9.9 million and $3.4 million and realized losses of $1.7 million and $9.7 million for the three months ended September 30, 2014 and 2013, respectively, and realized gains of $24.6 million and $15.6 million and realized losses of $6.1 million and $11.7 million for the nine months ended September 30, 2014 and 2013, respectively.

The Company had the following gross unrealized losses as of September 30, 2014 and December 31, 2013:

	Less than 12 months		12 months or longer		Total	
(in thousands)	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses
September 30, 2014						
Debt securities:						
U.S. Treasury bonds	$ 14,107	$ (81)	$ 16,465	$ (237)	$ 30,572	$ (318)
Municipal bonds	74,804	(429)	31,327	(468)	106,131	(897)
Foreign bonds	31,320	(132)	3,947	(31)	35,267	(163)
Governmental agency bonds	32,030	(164)	129,625	(3,097)	161,655	(3,261)
Governmental agency mortgage-backed securities	420,991	(2,535)	357,138	(10,853)	778,129	(13,388)
Non-agency mortgage-backed	2,041	(7)	6,063	(1,050)	8,104	(1,057)

securities						
Corporate debt securities	298,259	(3,797)	12,327	(187)	310,586	(3,984)
Total debt securities	873,552	(7,145)	556,892	(15,923)	1,430,444	(23,068)
Equity securities	264,336	(8,638)	4,069	(201)	268,405	(8,839)
Total	$1,137,888	$(15,783)	$560,961	$(16,124)	$1,698,849	$(31,907)
December 31, 2013						
Debt securities:						
U.S. Treasury bonds	$37,492	$(685)	$—	$—	$37,492	$(685)
Municipal bonds	230,180	(8,938)	27,687	(1,353)	257,867	(10,291)
Foreign bonds	56,579	(626)	—	—	56,579	(626)
Governmental agency bonds	203,011	(5,375)	131	(26)	203,142	(5,401)
Governmental agency mortgage-backed securities	838,411	(20,970)	124,425	(4,284)	962,836	(25,254)
Non-agency mortgage-backed securities	—	—	12,086	(1,803)	12,086	(1,803)
Corporate debt securities	129,394	(2,422)	12,500	(666)	141,894	(3,088)
Total debt securities	1,495,067	(39,016)	176,829	(8,132)	1,671,896	(47,148)
Equity securities	85,112	(2,718)	1,046	(42)	86,158	(2,760)
Total	$1,580,179	$(41,734)	$177,875	$(8,174)	$1,758,054	$(49,908)

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Substantially all securities in the Company's non-agency mortgage-backed portfolio are senior tranches and all were investment grade at the time of purchase, however, all have subsequently been downgraded to below investment grade. The table below summarizes the composition of the Company's non-agency mortgage-backed securities as of September 30, 2014, by collateral type and year of issuance.

(in thousands, except number of securities)	Number of Securities	Amortized Cost	Estimated Fair Value
Non-agency mortgage-backed securities:			
Prime single family residential:			
2007	1	$ 3,129	$ 2,643
2006	3	8,079	7,755
2005	1	639	620
Alt-A single family residential:			
2007	1	5,399	6,533
	6	$ 17,246	$ 17,551

The amortized cost and estimated fair value of debt securities at September 30, 2014, 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	$ 9,805	$37,719	$20,956	$2,429	$70,909
Estimated fair value	$ 9,884	$37,671	$21,109	$2,659	$71,323
Municipal bonds					
Amortized cost	$ 16,092	$249,478	$160,318	$108,977	$534,865
Estimated fair value	$ 16,211	$252,825	$164,186	$111,414	$544,636
Foreign bonds					
Amortized cost	$ 42,387	$138,724	$15,349	$3,422	$199,882
Estimated fair value	$ 42,602	$139,741	$15,333	$3,421	$201,097
Governmental agency bonds					
Amortized cost	$ 3,773	$116,699	$72,092	$11,982	$204,546

Estimated fair value	$ 3,786	$115,437	$70,495	$12,509	$202,227
Corporate debt securities					
Amortized cost	$ 20,744	$236,608	$253,537	$35,320	$546,209
Estimated fair value	$ 20,966	$239,858	$252,722	$35,662	$549,208
Total debt securities excluding mortgage-backed securities					
Amortized cost	$ 92,801	$779,228	$522,252	$162,130	$1,556,411
Estimated fair value	$ 93,449	$785,532	$523,845	$165,665	$1,568,491
Total mortgage-backed securities					
Amortized cost					$1,540,189
Estimated fair value					$1,532,393
Total debt securities					
Amortized cost					$3,096,600
Estimated fair value					$3,100,884

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.

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Other-than-temporary impairment — debt securities

If the Company intends to sell a debt security in an unrealized loss position or determines that it is more likely than not that the Company will be required to sell a debt security before it recovers its amortized cost basis, the debt security is other-than-temporarily impaired and it is written down to fair value with all losses recognized in earnings. As of September 30, 2014, the Company did not intend to sell any debt securities in an unrealized loss position and it is not more likely than not that the Company will be required to sell debt securities before recovery of their amortized cost basis.

If the Company does not expect to recover the amortized cost basis of a debt security with declines in fair value (even if the Company does not intend to sell the debt security and it is not more likely than not that the Company will be required to sell the debt security), the losses the Company considers to be the credit portion of the other-than-temporary impairment loss ("credit loss") is recognized in earnings and the non-credit portion is recognized in other comprehensive income. The credit loss is the difference between the present value of the cash flows expected to be collected and the amortized cost basis of the debt security. The cash flows expected to be collected are discounted at the rate implicit in the security immediately prior to the recognition of the other-than-temporary impairment.

Expected future cash flows for debt securities are based on qualitative and quantitative factors specific to each security, including the probability of default and the estimated timing and amount of recovery. The detailed inputs used to project expected future cash flows may be different depending on the nature of the individual debt security.

The Company determines if a non-agency mortgage-backed security in a loss position is other-than-temporarily impaired by comparing the present value of the cash flows expected to be collected from the security to its amortized cost basis. If the present value of the cash flows expected to be collected exceed the amortized cost of the security, the Company concludes that the security is not other-than-temporarily impaired. The Company performs this analysis on all non-agency mortgage-backed securities in its portfolio that are in an unrealized loss position. For the securities that were determined not to be other-than-temporarily impaired at September 30, 2014, the present value of the cash flows expected to be collected exceeded the amortized cost of each security.

Cash flows expected to be collected for each non-agency mortgage-backed security are estimated by analyzing loan-level detail to estimate future cash flows from the underlying assets, which are then applied to the security based on the underlying contractual provisions of the securitization trust that issued the security (e.g., subordination levels, remaining payment terms, etc.). The Company uses third-party software to determine how the underlying collateral cash flows will be distributed to each security issued from the securitization trust. The primary assumptions used in estimating future collateral cash flows are prepayment speeds, default rates and loss severity. In developing these assumptions, the Company considers the financial condition of the borrower, loan to value ratio, loan type and geographical location of the underlying property. The Company utilizes publicly available information related to specific assets, generally available market data such as forward interest rate curves and securities, loans and property data and market analytics tools provided through a third party.

The table below summarizes the primary assumptions used at September 30, 2014 in estimating the cash flows expected to be collected for these securities.

	Weighted average	Range
Prepayment speeds	9.9 %	8.1 %-10.8 %
Default rates	2.7 %	1.3 %-4.9 %
Loss severity	18.0 %	2.8 %-30.5 %

As a result of the Company's security-level review, the Company did not recognize any other-than-temporary impairments considered to be credit related on its non-agency mortgage-backed securities for the three months ended September 30, 2014, and recognized $1.0 million of other-than-temporary impairments in earnings for the nine months ended September 30, 2014. The Company did not recognize any other-than-temporary impairments considered to be credit related for the three and nine months ended September 30, 2013. It is possible that the Company could recognize additional other-than-temporary impairment losses on securities it owns at September 30, 2014 if future events or information cause it to determine that a decline in fair value is other-than-temporary.

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The following table presents the change in the credit portion of the other-than-temporary impairments recognized in earnings on debt securities for which a portion of the other-than-temporary impairments related to other factors was recognized in other comprehensive income (loss) for the three and nine months ended September 30, 2014 and 2013.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(in thousands)	2014	2013	2014	2013
Cumulative credit loss on debt securities held at beginning of period	$ 17,511	$ 16,478	$ 16,478	$ 16,478
Addition to credit loss for which an other-than-temporary impairment was previously recognized	—	—	1,033	—
Cumulative credit loss on debt securities held at end of period	$ 17,511	$ 16,478	$ 17,511	$ 16,478

Other-than-temporary impairment — equity securities

When a decline in the fair value of an equity security, including common and preferred stock, is considered to be other-than-temporary, such equity security is written down to its fair value. When assessing if a decline in fair value is other-than-temporary, the factors considered include the length of time and extent to which fair value has been below cost, the probability that the Company will be unable to collect all amounts due under the contractual terms of the security, the seniority of the securities, issuer-specific news and other developments, the financial condition and prospects of the issuer (including credit ratings), macro-economic changes (including the outlook for industry sectors, which includes government policy initiatives) and the Company's ability and intent to hold the security for a period of time sufficient to allow for any anticipated recovery.

When an equity security has been in an unrealized loss position for greater than twelve months, the Company's review of the security includes the above noted factors as well as other evidence that might exist supporting the view that the security will recover its value in the foreseeable future, typically within the next twelve months. If objective, substantial evidence does not indicate a likely recovery during that timeframe, the Company's policy is that such losses are considered other-than-temporary and therefore an impairment loss is recorded. For the three and nine months ended September 30, 2014 and 2013, the Company did not record other-than-temporary impairment losses related to its equity securities.

Fair value measurement

The Company classifies the fair value of its debt and equity securities 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 reporting entity (observable inputs) and the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The hierarchy level assigned to each security in the Company's available-for-sale portfolio is based on management's assessment of the transparency and reliability of the inputs used in the valuation of such instrument 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 securities.

Level 2—Valuations based on observable inputs (other than Level 1 prices), such as quoted prices for similar assets 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, a financial security's hierarchy level is based upon the lowest level of input that is significant to the fair value measurement. The valuation techniques and inputs used to estimate the fair value of the Company's debt and equity securities are summarized as follows:

Debt Securities

The fair value of debt securities was 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 bonds, governmental agency bonds, governmental agency mortgage-backed securities and 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. The fair value of non-agency mortgage-backed securities was obtained from the independent pricing services referenced above and subject to the Company's validation procedures discussed above. However, since these securities were not actively traded and there were fewer observable inputs available requiring the pricing services to use more judgment in determining the fair value of the securities, they were classified as Level 3.

The significant unobservable inputs used in the fair value measurement of the Company's non-agency mortgage-backed securities include prepayment rates, default rates and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for default rates is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

Equity Securities

The fair value 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.

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The following table presents the Company’s available-for-sale investments measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013, classified using the three-level hierarchy for fair value measurements:

(in thousands)	Estimated fair value	Level 1	Level 2	Level 3
September 30, 2014				
Debt securities:				
U.S. Treasury bonds	$71,323	$—	$71,323	$—
Municipal bonds	544,636	—	544,636	—
Foreign bonds	201,097	—	201,097	—
Governmental agency bonds	202,227	—	202,227	—
Governmental agency mortgage-backed securities	1,514,842	—	1,514,842	—
Non-agency mortgage-backed securities	17,551	—	—	17,551
Corporate debt securities	549,208	—	549,208	—
	3,100,884	—	3,083,333	17,551
Equity securities:				
Preferred stocks	16,758	16,758	—	—
Common stocks	376,983	376,983	—	—
	393,741	393,741	—	—
	$3,494,625	$393,741	$3,083,333	$17,551

(in thousands)	Estimated fair value	Level 1	Level 2	Level 3
December 31, 2013				
Debt securities:				
U.S. Treasury bonds	$66,384	$—	$66,384	$—
Municipal bonds	485,965	—	485,965	—

Foreign bonds	222,508	—	222,508	—
Governmental agency bonds	262,545	—	262,545	—
Governmental agency mortgage-backed securities	1,403,309	—	1,403,309	—
Non-agency mortgage-backed securities	19,022	—	—	19,022
Corporate debt securities	360,084	—	360,084	—
	2,819,817	—	2,800,795	19,022
Equity securities:				
Preferred stocks	11,085	11,085	—	—
Common stocks	346,958	346,958	—	—
	358,043	358,043	—	—
	$3,177,860	$358,043	$2,800,795	$19,022

The Company did not have any transfers in and out of Level 1, Level 2 and Level 3 measurements during the three and nine months ended September 30, 2014 and 2013. The Company's policy is to recognize transfers between levels in the fair value hierarchy at the end of the reporting period.

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The following table presents a summary of the changes in fair value of Level 3 available-for-sale investments for the three and nine months ended September 30, 2014 and 2013:

(in thousands)	For the Three Months Ended September 30, 2014	2013	For the Nine Months Ended September 30, 2014	2013
Non-agency mortgage-backed securities:				
Fair value at beginning of period	$ 17,994	$ 20,611	$ 19,022	$ 21,846
Total gains/(losses) (realized and unrealized):				
Included in earnings:				
Net other-than-temporary impairment losses recognized in earnings	—	—	(1,033)	—
Included in other comprehensive income	252	907	941	1,028
Settlements	(695)	(1,215)	(1,379)	(2,571)
Fair value at end of period	$ 17,551	$ 20,303	$ 17,551	$ 20,303
Unrealized gains (losses) included in earnings for the period relating to Level 3 available-for-sale investments that were still held at the end of the period:				
Net other-than-temporary impairment losses recognized in earnings	$ —	$ —	$ (1,033)	$ —

The Company did not purchase or sell any non-agency mortgage-backed securities during the three and nine months ended September 30, 2014 and 2013.

Note 4 – Financing Receivables

Financing receivables are summarized as follows:

	September 30, 2014	December 31, 2013
	(in thousands)	
Loans receivable, net:		
Real estate—mortgage		
Multi-family residential	$7,094	$ 7,455
Commercial	50,419	69,865
Other	394	712
	57,907	78,032
Allowance for loan losses	(3,628)	