

# **North Carolina Joint Underwriting Association**

Statutory Financial Statements  
With Independent Auditor's Report Thereon  
September 30, 2010 and 2009

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**Independent Auditor's Report**

To the Board of Directors  
North Carolina Joint Underwriting Association  
Cary, North Carolina

We have audited the accompanying statutory statements of admitted assets, liabilities and members' surplus of North Carolina Joint Underwriting Association (the "Association") as of September 30, 2010 and 2009, and the related statutory statements of operations and changes in members' surplus, and cash flows for the years then ended. These statutory financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Association's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note 1 to the financial statements, the Association prepared these statutory financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of North Carolina, which practices differ from accounting principles generally accepted in the United States of America. The effects on the statutory financial statements of the variances between the statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the Association as of September 30, 2010 and 2009, or the results of its operations or its cash flows for the years then ended.

The Association did not prepare and include with the basic statutory financial statements the supplementary information required by accounting practices prescribed or permitted by the Insurance Department of the State of North Carolina. In our opinion, disclosure of this information is required by statutory accounting practices.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and members' surplus of the Association as of September 30, 2010 and 2009, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note 1.



Raleigh, North Carolina  
March 3, 2011

**North Carolina Joint Underwriting Association**

**Statutory Statements of Admitted Assets, Liabilities, and Members' Surplus**  
**September 30, 2010 and 2009**

|  | <b>2010</b>          | <b>2009</b>          |
|--|----------------------|----------------------|
| <b>Admitted Assets</b>   |                      |                      |
| Cash and short-term investments  | \$ 16,158,184        | \$ 23,340,415        |
| Bonds (Note 3)   | 31,174,715           | 24,585,501           |
| <b>Cash and invested assets</b>  | <b>47,332,899</b>    | <b>47,925,916</b>    |
| Interest income due and accrued  | 267,637              | 233,931              |
| Net due from North Carolina Insurance Underwriting Association (Note 5)                                  | -                    | 356,680              |
| Other receivables, net   | 45,930               | 680,373              |
| Data processing equipment, at cost less accumulated depreciation of \$587,935 in 2010; \$573,824 in 2009 | 64,903               | 89,658               |
| <b>Total admitted assets</b>   | <b>\$ 47,711,369</b> | <b>\$ 49,286,558</b> |
| <b>Liabilities and Members' Surplus</b>  |                      |                      |
| Liabilities:   |                      |                      |
| Unpaid losses (Note 4)   | \$ 3,297,281         | \$ 2,347,880         |
| Unpaid loss adjustment expenses (Note 4)   | 254,766              | 157,844              |
| Unearned premiums  | 13,452,196           | 13,265,071           |
| Remittances and items not allocated  | 1,057,777            | 1,142,820            |
| Net due to North Carolina Insurance Underwriting Association (Note 5)                                    | 1,420,357            | -                    |
| Accounts payable and accrued expenses (Note 9)   | 1,388,259            | 1,182,437            |
| <b>Total liabilities</b>   | <b>20,870,636</b>    | <b>18,096,052</b>    |
| Commitments and contingencies (Notes 6 and 7)  |                      |                      |
| Members' surplus   | <b>26,840,733</b>    | <b>31,190,506</b>    |
| <b>Total liabilities and members' surplus</b>  | <b>\$ 47,711,369</b> | <b>\$ 49,286,558</b> |

See Notes to Statutory Financial Statements.

**North Carolina Joint Underwriting Association**

**Statutory Statements of Operations and Changes in Members' Surplus**  
**Years Ended September 30, 2010 and 2009**

|   | <b>2010</b>          | <b>2009</b>          |
|---|----------------------|----------------------|
| Direct premiums written                                 | \$ 25,922,170        | \$ 25,666,085        |
| Change in unearned premiums                             | (187,125)            | 818,518              |
| Ceded reinsurance premiums                              | <u>(8,258,062)</u>   | <u>(7,789,451)</u>   |
|   | <b>17,476,983</b>    | <b>18,695,152</b>    |
| Underwriting expenses (Notes 4, 6 and 9):               |                      |                      |
| Losses incurred   | 10,263,983           | 9,517,778            |
| Loss adjustment expenses incurred                       | 727,265              | 634,449              |
| Commissions   | 3,824,574            | 3,779,144            |
| Salaries and benefits                                   | 1,031,956            | 1,049,482            |
| Insurance taxes, licenses and fees                      | 1,100,345            | 1,098,721            |
| Other underwriting expenses                             | <u>845,234</u>       | <u>987,477</u>       |
| <b>Total underwriting deductions</b>                    | <b>17,793,357</b>    | <b>17,067,051</b>    |
| <br><b>Net underwriting gain (loss)</b>                 | <br><b>(316,374)</b> | <br>1,628,101        |
| Investment income:                                      |                      |                      |
| Interest income   | 1,087,329            | 1,176,278            |
| <b>Net income</b>                                       | <b>770,955</b>       | <b>2,804,379</b>     |
| Members' surplus:                                       |                      |                      |
| Beginning   | 31,190,506           | 23,177,304           |
| Distributions to members (Note 8)                       | (5,372,358)          | (98,421)             |
| Assessments of members (Note 8)                         | 100,134              | 5,359,030            |
| Change in additional minimum pension liability (Note 9) | 97,618               | (191,430)            |
| Change in nonadmitted assets                            | <u>53,878</u>        | <u>139,644</u>       |
| Ending  | <b>\$ 26,840,733</b> | <b>\$ 31,190,506</b> |

See Notes to Statutory Financial Statements.

**North Carolina Joint Underwriting Association**

**Statutory Statements of Cash Flows**  
**Years Ended September 30, 2010 and 2009**

|  | <b>2010</b>          | <b>2009</b>          |
|--|----------------------|----------------------|
| <b>Cash Flows From Operations</b>  |                      |                      |
| Premiums collected net of reinsurance  | \$ 17,767,636        | \$ 18,008,694        |
| Losses and loss adjustment expenses paid                                     | (9,944,925)          | (10,220,710)         |
| Net interest income  | 1,053,623            | 1,176,308            |
| Underwriting expenses paid   | (4,830,123)          | (7,250,855)          |
| <b>Net cash from operations</b>  | <b>4,046,211</b>     | <b>1,713,437</b>     |
| <b>Cash Flows From Investments</b>   |                      |                      |
| Cost of long-term investments acquired:                                      |                      |                      |
| Bonds and other debt instruments   | (9,441,266)          | (3,866,799)          |
| Proceeds from investments sold, matured or repaid:                           |                      |                      |
| Bonds  | 2,852,051            | 1,296,100.00         |
| <b>Net cash used in investments</b>  | <b>(6,589,215)</b>   | <b>(2,570,699)</b>   |
| <b>Cash Flows From Financing and Miscellaneous Sources</b>                   |                      |                      |
| Member assessments   | 733,131              | 4,726,033            |
| Member distributions   | (5,372,358)          | (98,421)             |
| <b>Net cash (used in) provided by financing and miscellaneous sources</b>    | <b>(4,639,227)</b>   | <b>4,627,612</b>     |
| <b>Net (decrease) increase in cash and short-term investments</b>            | <b>(7,182,231)</b>   | <b>3,770,350</b>     |
| <b>Cash and short-term investments:</b>                                      |                      |                      |
| Beginning  | 23,340,415           | 19,570,065           |
| Ending   | <b>\$ 16,158,184</b> | <b>\$ 23,340,415</b> |
| <b>Supplemental Disclosure of Noncash Investing and Financing Activities</b> |                      |                      |
| Accounts receivable for Member assessments                                   | \$ -                 | \$ 632,997           |

See Notes to Statutory Financial Statements.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 1. Nature of Organization and Significant Accounting Policies

North Carolina Joint Underwriting Association (the “Association”) was formed August 15, 1969 as an association of insurance companies (“Members”) mandated by North Carolina law authorized to write fire, extended coverage and vandalism and malicious mischief coverage in the State of North Carolina. The purpose of the Association is to assist applicants in securing adequate property insurance in North Carolina when not obtainable in the customary insurance market. The majority of the Association’s policies are submitted by independent producers, who remit premiums directly to the Association.

The Association is administered by a Board of Directors elected by the Members and is subject to the supervision of the Commissioner of Insurance of the State of North Carolina. The manager of the Association is appointed by the Board of Directors.

A summary of the Association’s significant accounting policies is as follows:

**Risk and uncertainties:** Certain risks and uncertainties are inherent in the Association’s day to day operations and to the process of preparing its statutory financial statements. The more significant of those risks and uncertainties are presented below and throughout the notes to the statutory financial statements.

**Estimates:** The preparation of the statutory financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the statutory financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Loss reserves:** The Association estimates loss and loss adjustment expenses subsequent to consultation with the Association’s independent actuary net of deductions of amounts for reinsurance ceded. Actual results could differ from these estimates.

**Investments:** The Association is exposed to risks that issuers of securities owned by the Association will default or that interest rates will change and cause a decrease in the value of the Association’s investments. With mortgage-backed securities, the Association is exposed to prepayment risk. As interest rates decline, the rate at which these securities pay down principal will generally increase. Management mitigates these risks by conservatively investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.

**Basis of presentation:** At the direction of the Commissioner of Insurance of the State of North Carolina, the Association presents its financial statements on the basis of accounting practices prescribed or permitted by the North Carolina Department of Insurance. The State of North Carolina has adopted the National Association of Insurance Commissioners’ (“NAIC”) statutory accounting practices (“SAP”) as the basis of its statutory accounting practices.

In addition, the Commissioner of the North Carolina Department of Insurance has the right to permit other specific practices that may deviate from prescribed practices. There is no deviation from the NAIC Accounting Practices and Procedures Manual.

## North Carolina Joint Underwriting Association

### **Notes to Statutory Financial Statements**

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#### **Note 1. Nature of Organization and Significant Accounting Policies (Continued)**

Accounting practices and procedures of the NAIC as prescribed or permitted by the insurance department of the applicable state of domicile comprise a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America ("GAAP"). The more significant differences are as follows:

Investments in bonds and other debt instruments are generally reported at amortized cost, unless required to be reported at market value by NAIC regulations. Under GAAP, investments in debt securities are designated at purchase as held-to-maturity, trading securities, or available-for-sale. Held to maturity debt securities are reported at amortized cost, less applicable valuation allowances, and other debt securities are reported at fair value under GAAP. For debt securities designated as trading, unrealized holding gains and losses are reported in operations and for those designated as available-for-sale, unrealized holding gains and losses are reported as a separate component of equity, under GAAP.

Beginning with the Association's fiscal year that began October 1, 2009, for loan-backed and structured securities, if the Association determines that they intend to sell a security or no longer have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security shall be written down to fair value. For statutory purposes, if the Association subsequently changes its assertion, and now believes it does not intend to sell the security and has the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security will continue to be carried at the lower of cost or market with any future decreases in fair value charged through operations until the security is disposed. For GAAP purposes, once the Association alters its assertion, the securities' amortized cost basis will not be decreased for future reductions in fair value unless an other than temporary impairment is determined to have occurred.

Also, beginning with the 2009 fiscal year, for GAAP purposes other-than-temporary impairment losses (related to non loan-backed and structured securities) related to debt securities are bifurcated between credit and non-credit, where for statutory purposes the total other-than-temporary impairment loss is reported in earnings.

Commissions, premium taxes and other costs relating to the acquisition, issuance and renewal of policies are charged to operations as incurred, rather than being deferred and amortized over the term of the policy.

Certain assets, described as nonadmitted, are excluded from the balance sheet by direct charges to surplus. In accordance with GAAP, such assets are recorded on the balance sheet, net of valuation allowances.

Comprehensive income is not determined for SAP; whereas for GAAP, such income is determined.

The defined benefit pension and postretirement obligations are determined excluding non-vested employees. Under GAAP, non-vested employees are included in the valuations.

If the accumulated benefit obligation exceeds the fair value of the defined benefit pension plan's assets, a minimum pension liability is required and recorded through surplus in the current year under SAP. Under GAAP, the funded status (plan assets less than benefit obligations) of the Plan is recognized on the balance sheet as an asset or liability with a corresponding charge or credit to accumulated other comprehensive income.

## North Carolina Joint Underwriting Association

### **Notes to Statutory Financial Statements**

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#### **Note 1. Nature of Organization and Significant Accounting Policies (Continued)**

Assets and liabilities related to insurance and reinsurance activities are netted in financial statements prepared on the basis of SAP. Under GAAP, those assets and liabilities would be reported at their gross amounts.

Under SAP, cash and short-term investments represent cash balances and investments with an initial maturity of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents include cash balances and investments with an initial maturity of three months or less.

**Cash and short-term investments:** Cash constitutes a medium of exchange that a bank will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash for financial statement purposes, although not falling within the above description of cash, are cash equivalents which include savings accounts and certificates of deposit in banks and other similar institutions with maturity dates of one year or less from the date of acquisition. At times cash deposits with a financial institution may exceed federally insured limits. The Association has not experienced any credit losses related to such deposits and its management is not aware of any events or circumstances which would raise doubt about the ongoing solvency of the institution.

Investments with remaining maturities of one year or less at the time of acquisition (excluding those investments defined as cash equivalents above) are considered short-term investments. From time to time the Association holds investments in money market instruments that are reported in accordance with the guidance in the NAIC *Purposes and Procedures of the Securities Valuation Office* ("SVO"), which is generally the reported net asset value.

**Investments:** Bonds are reported at amortized cost in the accompanying statutory financial statements. Prepayment assumptions for asset-backed securities were obtained from broker dealer survey values or internal estimates. Realized gains and losses on sales of investments are recognized in the statutory statements of operations on a specific-identification basis. Declines in fair value that are considered other-than-temporary are charged to realized losses and the cost of the investment is adjusted to estimated fair value in the period when the determination is made. In determining whether these losses are expected to be temporary, the Association considers severity of impairment, duration of impairment, forecasted market price recovery, and the intent and ability of the Association to hold the investment until the market price has recovered.

For the Association's fiscal year beginning October 1, 2009, for loan-backed or structured securities, factors considered by management in determining whether an other-than-temporary impairment exists include the Association's stated intent to not sell, the Association's ability to hold such investments until the fair value recovers, and the discounted cash flows of the security based on the yield at the date of acquisition. If the Association intends to sell or if the Association does not have the ability and intent to hold the security for a period of time sufficient to recover its amortized cost basis, an other-than-temporary impairment exists, and the security is written down to fair value with the amount of the write-down recorded as a realized loss. If the Association does not intend to sell the security and has the ability and intent to hold the security for a period of time sufficient to recover the amortized cost basis, the Association calculates the cash flows expected to be collected. In this calculation, the Association compares the present value of cash flows expected to be collected, discounted at the security's effective interest rate at date of purchase, to the amortized cost basis. If the present value of cash flows is less than the amortized cost basis, a realized loss is recorded for the difference. The present value of cash flows then becomes the new cost basis.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 1. Nature of Organization and Significant Accounting Policies (Continued)

**Accrued investment income:** The Association nonadmits investment income due and accrued if amounts are over 90 days past due. As of September 30, 2010 and 2009, the Association had no income due or accrued over 90 days past due.

**Premiums in course of collection:** The Association records premiums in course of collection at total unpaid balance, which approximates estimated fair value, net of any nonadmitted receivables. The Association determines past due status of individual accounts receivable based on the effective date of the policy and generally does not charge interest on past due amounts. Premiums that management believes to be ultimately not collectible are written off upon such determination. Any premiums considered to be past due 90 days or more are nonadmitted.

**Advanced Premiums:** When the Association receives premium payments from policyholders prior to the effective date of the related policy, the Association records an Advance Premiums liability. On the policy effective date, the Association reduces the advance premium liability and records the premiums as revenue

**Data processing equipment:** Data processing equipment is carried at cost less accumulated depreciation. The Association provides for depreciation on these admitted assets using the straight-line method over three to five years. Depreciation expense was \$149,058 and \$187,317 for the years ended September 30, 2010 and 2009, respectively. Maintenance and repairs are charged to expense as incurred.

**Nonadmitted assets:** Certain assets designated as nonadmitted assets have been charged directly to members' surplus. Amounts related to nonadmitted assets are as follows:

|   | 2010                    | 2009                    |
|---|-------------------------|-------------------------|
| Furniture and equipment, less accumulated depreciation<br>of \$649,134 in 2010; \$566,008 in 2009 | \$ 127,456              | \$ 208,385              |
| Prepaid expenses  | 70,055                  | 45,648                  |
| Accounts receivable, assessments  | 952                     | 96                      |
| Insolvent member companies receivable   | 16,982                  | 15,194                  |
|   | <hr/> <b>\$ 215,445</b> | <hr/> <b>\$ 269,323</b> |

Depreciation on nonadmitted assets (furniture and equipment) is computed by applying the straight-line method over the estimated useful lives of the related assets. Estimated lives are three to five years for furniture and equipment. This depreciation expense is reflected in the statements of operations with a corresponding credit to members' surplus.

**Reserves for losses and loss adjustment expenses:** Unpaid losses and loss adjustment expenses include an amount determined from individual case estimates and loss reports and an amount, based on past experience, for losses incurred but not reported. Such liabilities are necessarily based on assumptions and estimates and, while management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed and any adjustments are reflected in the period determined.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### **Note 1. Nature of Organization and Significant Accounting Policies (Continued)**

Establishing liabilities for claims is subject to significant uncertainties that make reserve estimation difficult. Legal decisions have tended to expand insurance coverage beyond the Association's intent of the original policies. The disposition of such requires lengthy and costly litigation. In establishing liabilities for claims, the Association considers all pertinent information as it becomes available and establishes incurred but not reported reserves where appropriate. Although the reserves are deemed adequate to cover all probable claims, there is a reasonable possibility that adverse development from prior accident years could occur in the future.

Estimates for catastrophic events are inherently more uncertain than those for non-catastrophic losses due to the unique circumstances involving a catastrophe. Due to the low frequency of historical catastrophic events, standard actuarial loss development methods are difficult to apply and may result in a wider range of estimates of ultimate catastrophic losses. Therefore, material changes to estimates related to these events are reasonably possible in the near term after these events occur, and are reflected in operations as more information becomes available.

**Reinsurance:** Reinsurance premiums and liabilities related to reinsurance ceded are accounted for on a basis consistent with that used in accounting for the original policies issued by the Association and the terms of the reinsurance contracts. Premiums and losses on reinsurance ceded are reported as reductions of premiums earned and losses and loss adjustment expenses incurred, respectively, in the statutory statements of operations and changes in members' surplus.

**Member participation:** Each member's participation in the operations of any fiscal year is in proportion to that member's North Carolina insurance writings for the affected lines of business in the preceding calendar year. Participation percentages vary from year to year. Assessments of members related to each fiscal year are based on their participation. Since the Association has the authority to assess its members to cover members' deficits, members can be assessed annually to meet the liquidity requirements of the Association. Special assessments are also permitted for large unanticipated losses.

**Premiums and related commissions:** Premiums are earned over the periods covered by the policies. Unearned premium reserves are established to cover the unexpired portion of premiums written. Expenses incurred related to the acquisition of new insurance business, including such acquisition costs as commissions, premium taxes and other underwriting expenses, are charged to expense when incurred.

**Income taxes:** In 1992, the Association received correspondence from the Internal Revenue Service ("IRS") indicating that it is tax-exempt under Section 501(c)(6) of the Internal Revenue Code and has relied on that correspondence for tax years after 1992. See Note 12.

**Newly adopted pronouncements:** In May 2009, the NAIC Working Group adopted as revisions to SSAP 9, *Events After the Balance Sheet Date*, based on the new guidance issued by the Financial Accounting Standards Board. This guidance was related to general standards of accounting for, and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The new guidance requires disclosure of the date through which an entity has evaluated subsequent events. The guidance was effective December 31, 2009. The Association adopted this guidance without a material impact on the statutory financial statements.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 1. Nature of Organization and Significant Accounting Policies (Continued)

**Newly issued pronouncements (not yet adopted):** In 2009, the NAIC adopted SSAP No. 100, Fair Value Measurements. SSAP No. 100 defines fair value, establishes a framework for measuring fair value and establishes disclosure requirements about fair value. This statement is effective for December 31, 2010 annual statutory financial statements. The Association anticipates the adoption of SSAP No. 100 will not have a material effect on the statutory financial statements.

#### Note 2. Legislative Changes to the Plan

Effective on August 26, 2009, the North Carolina General Assembly made changes to the statutes that govern the operations of the North Carolina Insurance Underwriting Association ("NCIUA"). Once the member companies of the NCIUA have paid \$1 billion in nonrecoupable assessments for losses and expenses incurred in any given year related to the Coastal Property Insurance Pool, the Association may authorize member companies to impose a catastrophe recovery charge on their residential and commercial property insurance policyholders statewide. Catastrophe recovery charges shall be charged as a uniform percentage of written premiums as prescribed by the North Carolina Commissioner of Insurance and shall not exceed an aggregate amount of 10% of the annual policy premium on any one policy of insurance. The catastrophe recovery charge amount shall continue until financing of any NCIUA financial deficit arising from the catastrophe event has been paid in full. Any charge amounts collected by the Association or the North Carolina Insurance Underwriting Association that exceed amounts necessary for payment of the Association's financial deficit shall be remitted to the North Carolina Insurance Underwriting Association and added to its surplus for the purposes of offsetting future Coastal Property Insurance Pool losses or expenses. The 2009 statutory changes did not have a material impact on the operations or financial statements for the years ended September 30, 2010 and 2009.

#### Note 3. Bonds

Amortized cost (admitted amount), aggregate market value and gross unrealized gains and losses pertaining to the portfolio of bonds as of September 30, 2010 and 2009 are as follows:

| September 30, 2010                        |                      |                        |                           |                      |  |
|---|----------------------|------------------------|---------------------------|----------------------|--|
|   | Amortized Cost       | Gross Unrealized Gains | Gross Unrealized (Losses) | Market Value         |  |
| U. S. Treasury obligations                | \$ 7,906,272         | \$ 684,838             | \$ -                      | \$ 8,591,110         |  |
| Federal agency obligations                | 22,306,160           | 1,272,421              | (3,169)                   | 23,575,412           |  |
| Federal agency mortgage-backed securities | 962,283              | 59,985                 | -                         | 1,022,268            |  |
|   | <b>\$ 31,174,715</b> | <b>\$ 2,017,244</b>    | <b>\$ (3,169)</b>         | <b>\$ 33,188,790</b> |  |

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

#### Note 3. Bonds (Continued)

| September 30, 2009                        |                      |                        |                           |                      |  |
|---|----------------------|------------------------|---------------------------|----------------------|--|
|   | Amortized Cost       | Gross Unrealized Gains | Gross Unrealized (Losses) | Market Value         |  |
| U. S. Treasury obligations                | \$ 5,895,256         | \$ 222,724             | \$ -                      | \$ 6,117,980         |  |
| Federal agency obligations                | 17,439,308           | 680,321                | (39,368)                  | 18,158,997           |  |
| Federal agency mortgage-backed securities | 1,250,937            | 66,793                 | -                         | 1,317,730            |  |
|   | <b>\$ 24,585,501</b> | <b>\$ 969,838</b>      | <b>\$ (39,368)</b>        | <b>\$ 25,594,707</b> |  |

Amortized cost and aggregate market value of bonds held as of September 30, 2010, according to final contractual maturity dates, are as indicated below. Actual future maturities will differ from the maturities shown because certain issuers have the right to call or prepay obligations.

|  | Amortized Cost       | Market Value         |
|--|----------------------|----------------------|
| Amounts due in less than one year                | \$ 4,005,498         | \$ 4,053,750         |
| Amounts due after one year through five years    | 15,173,527           | 16,024,722           |
| Amounts due after five years through ten years   | 9,206,231            | 10,077,188           |
| Amounts due after ten years through twenty years | 2,789,459            | 3,033,130            |
|  | <b>\$ 31,174,715</b> | <b>\$ 33,188,790</b> |

There were no sales of bonds and other debt instruments during the year ended September 30, 2010.

The following table shows unrealized gross losses and fair value, for the Association's investments, aggregated by individual category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2010:

|                            | 12 Months or Less |                   | More than 12 Months |                   | Total        |                   |
|----------------------------|-------------------|-------------------|---------------------|-------------------|--------------|-------------------|
|                            | Fair Value        | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value   | Unrealized Losses |
|                            |                   |                   |                     |                   |              |                   |
| Federal agency obligations | \$ 2,723,701      | \$ (3,169)        | \$ -                | \$ -              | \$ 2,723,701 | \$ (3,169)        |

The following table shows unrealized gross losses and fair value, for the Association's investments, aggregated by individual category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2009:

|                            | 12 Months or Less |                   | More than 12 Months |                   | Total        |                   |
|----------------------------|-------------------|-------------------|---------------------|-------------------|--------------|-------------------|
|                            | Fair Value        | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value   | Unrealized Losses |
|                            |                   |                   |                     |                   |              |                   |
| Federal agency obligations | \$ -              | \$ -              | \$ 1,020,630        | \$ (39,368)       | \$ 1,020,630 | \$ (39,368)       |

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 3. Bonds (Continued)

The Association evaluates impairment at each reporting period for each security (other than loan-backed or structured securities) where the fair value of the investment is less than its amortized cost. It is expected that the securities would not be settled at a price less than the amortized cost of the investment, as the Association has the ability and intent to hold the investment until recovery. The Association evaluated the credit ratings of these holdings, noting neither a significant deterioration since purchase nor other factors which may indicate an other-than-temporary impairment, such as the length of time and extent to which fair value has been less than cost, the financial condition and near-term prospects of the issuer as well as specific events or circumstances that may influence the operations of the issuer, and our intent and ability to hold the investment for a sufficient time in order to enable recovery of our cost.

For 2010, the Association evaluated each loan-backed and structured security for impairment where the fair value of the investment was less than its amortized cost. For those securities that the Association intends to sell or does not have the ability to hold until recovery, an impairment is recorded equal to the difference of amortized cost and fair value. For all other loan-backed and structured securities, the Association developed assumptions around prepayment speeds, expected default rates and the value of the underlying collateral. These assumptions were used to develop expected cash flows which were discounted at the effective yield at the date of acquisition (or most recent impairment). These modeled cash flows were compared against the current amortized cost basis. If the expected discounted cash flows were less than the amortized cost basis, the security was written down to the discounted cash flow amount, with the difference recorded as a realized loss.

Investment income, net of investment expenses, which are not material, for the fiscal years ending September 30, 2010 and 2009 is comprised of primarily interest on bonds and short-term investments.

#### Note 4. Reserve for Losses and Loss Adjustment Expenses

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

|                         | 2010                | 2009                |
|-------------------------|---------------------|---------------------|
| Balance at October 1    | <u>\$ 2,505,724</u> | <u>\$ 2,574,207</u> |
| Incurred related to:    |                     |                     |
| Current year            | 11,471,675          | 10,724,600          |
| Prior years             | (480,427)           | (572,373)           |
| Total incurred          | <u>10,991,248</u>   | <u>10,152,227</u>   |
| Paid related to:        |                     |                     |
| Current year            | (8,415,686)         | (8,582,660)         |
| Prior years             | (1,529,239)         | (1,638,050)         |
| Total paid              | <u>(9,944,925)</u>  | <u>(10,220,710)</u> |
| Balance at September 30 | <u>\$ 3,552,047</u> | <u>\$ 2,505,724</u> |

As a result of changes in estimates related to insured events of prior years, the provision for losses and loss adjustment expenses was adjusted as indicated in the table above. The decrease in prior year incurred losses and loss adjustment expenses in 2010 and 2009 resulted from favorable development of claims on an overall basis. No individual events were responsible for a large change in prior year incurred claims.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 4. Reserve for Losses and Loss Adjustment Expenses (Continued)

The components of unpaid losses and loss adjustment expenses as of September 30, 2010 and 2009 are as follows:

|                                  | <b>2010</b>         | <b>2009</b>         |
|----------------------------------|---------------------|---------------------|
| Unpaid losses:                   |                     |                     |
| Case basis                       | \$ 1,748,344        | \$ 1,499,725        |
| Incurred but not reported        | 1,548,937           | 848,155             |
|                                  | <b>\$ 3,297,281</b> | <b>\$ 2,347,880</b> |
| Unpaid loss adjustment expenses: |                     |                     |
| Case basis                       | \$ 129,987          | \$ 113,373          |
| Incurred but not reported        | 124,779             | 44,471              |
|                                  | <b>\$ 254,766</b>   | <b>\$ 157,844</b>   |
|                                  | <b>\$ 3,552,047</b> | <b>\$ 2,505,724</b> |

#### Note 5. Related Party Transactions

A related organization, North Carolina Insurance Underwriting Association ("NCIUA"), shares the same facility and is operated by the same personnel as the Association. This arrangement periodically results in receivables or payables between the two associations. Shared expenses are allocated between the two parties with 29% allocated to the Association and the remainder to NCIUA, except for furniture and equipment costs which are shared equally. If this cost sharing arrangement was not in place, the actual expense amounts for the Association would vary from the amounts reported in the statutory financial statements. At September 30, 2010, the Association had a net payable to NCIUA of \$1,420,357. At September 30, 2009, the Association had a net admitted receivable from NCIUA of \$356,680.

#### Note 6. Lease Commitments

The Association and the NCIUA jointly rent home office facilities under an operating lease agreement, which expires in calendar year 2014. Although the lease is in the name of the Association, the Association was allocated 29% of the costs under this lease agreement in 2010 and 2009. The Association's allocated share of rent expense was \$99,069 and \$99,173 in 2010 and 2009, respectively. The Association also leases certain equipment jointly with the NCIUA.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 6. Lease Commitments (Continued)

The Association's share of the rent commitments, based on current cost sharing provisions with NCIUA, under the terms of operating lease agreements at September 30, 2010 is as follows:

| Year Ending<br>September 30, | Amount            |
|------------------------------|-------------------|
| 2011                         | \$ 175,121        |
| 2012                         | 144,208           |
| 2013                         | 139,093           |
| 2014                         | 142,770           |
| 2015                         | 23,897            |
| Thereafter                   | -                 |
|                              | <u>\$ 625,089</u> |

The Association is also required to pay a proportionate share of operating expense increases during the lease term for the building.

#### Note 7. Litigation

In the ordinary course of business, the Association from time-to-time is involved in lawsuits filed under various causes of action. Ultimate disposition of these actions will not have a material effect on the Association's financial condition.

#### Note 8. Assessments of and Distributions to Members

Under North Carolina law, the Association may make assessments of its members and may also make periodic distributions to its members.

An assessment totaling \$100,134 and a distribution totaling \$5,372,358 were made in fiscal year 2010. An assessment totaling \$5,359,030 and a distribution totaling \$98,421 were made in fiscal year 2009.

There were no amounts owed to/due from Association members at September 30, 2010 or 2009.

#### Note 9. Employee Benefit Plans

The Association and the NCIUA are members of a multiple-employer pension trust. Plan assets are held in a single trust for all employers who participate in the Plan. Each year, assets are allocated to the Association based on its historical contributions, benefit disbursements, and share of investment return. Employees who are hired before age 60 and who are scheduled to work 1,000 hours in a 12-month period are eligible for the plan upon their date of hire. No employee contributions are required. The Association's funding policy is to make the minimum annual contributions required by applicable regulations, which are based on recommendations from the plan's actuary. For 2010 and 2009, the Association is allocated 29% of the costs and obligations associated with their participation in the plan under the current cost-sharing arrangement with the NCIUA.

The Association uses a September 30 measurement date for its plans.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

#### Note 9. Employee Benefit Plans (Continued)

##### Obligations and Funded Status

|  | Pension Benefits    |                     |
|--|---------------------|---------------------|
|  | 2010                | 2009                |
| Changes in benefit obligations:  |                     |                     |
| Obligations at beginning of year   | \$ 1,205,127        | \$ 1,129,026        |
| Service cost   | 77,673              | 53,608              |
| Interest cost  | 69,320              | 64,848              |
| Plan amendments  | -                   | (214)               |
| Participant contributions  | -                   | -                   |
| Actuarial (gains) losses   | (96,305)            | 257,555             |
| Benefits paid  | (37,954)            | (32,296)            |
| Change in cost sharing with NCIUA  | -                   | (267,400)           |
| <b>    Obligations at end of year</b>  | <b>1,217,861</b>    | <b>1,205,127</b>    |
| Changes in plan assets:  |                     |                     |
| Fair value of assets at beginning of year, primarily pooled separate accounts with insurance companies and mutual funds                                    | 762,731             | 831,264             |
| Actual return on assets  | 78,334              | 90,297              |
| Association contributions  | 108,691             | 70,343              |
| Participant contributions  | -                   | -                   |
| Benefits paid  | (37,954)            | (32,296)            |
| Change in cost sharing with NCJUA  | -                   | (196,878)           |
| <b>    Fair value of assets at end of year, primarily pooled separate accounts with insurance companies and mutual funds</b>                               | <b>911,802</b>      | <b>762,730</b>      |
| Funded status (plan assets less than benefit obligations) at end of years  | (306,059)           | (442,397)           |
| Amounts not recognized on statutory statements of admitted assets, liabilities, and members' surplus before additional minimum pension liability:          |                     |                     |
| Unrecognized net loss  | 236,112             | 381,210             |
| Prior service cost   | (193)               | (214)               |
| <b>    Net amount recognized on statutory statements of admitted assets, liabilities, and members' surplus before additional minimum pension liability</b> | <b>(70,140)</b>     | <b>(61,401)</b>     |
| Amounts recognized on statutory statements of admitted assets, liabilities, and members' surplus as:   |                     |                     |
| Accrued benefit cost   | (70,140)            | (61,401)            |
| Adjustment to record to additional minimum liability   | (85,073)            | (191,430)           |
| <b>    Net amount recognized on statutory statements of admitted assets, liabilities, and members' surplus</b>   | <b>\$ (155,213)</b> | <b>\$ (252,831)</b> |
| Aggregate accumulated benefit obligation for defined benefit pension plan  | \$ 1,067,016        | \$ 1,015,562        |
| For pension plan with accumulated benefit obligation in excess of assets at September 30 of the respective years:  |                     |                     |
| Projected benefit obligation   | 1,217,861           | 1,205,127           |
| Accumulated benefit obligation   | 1,067,016           | 1,015,561           |
| Fair value of plan assets  | 911,802             | 762,730             |

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 9. Employee Benefit Plans (Continued)

##### Components of Net Periodic Benefit Cost and Additional Information

|  | Pension Benefits |               |
|--|------------------|---------------|
|  | 2010             | 2009          |
| Components of net periodic benefit cost: |                  |               |
| Service cost                             | \$ 77,673        | \$ 53,608     |
| Interest cost                            | 69,320           | 64,848        |
| Recognized actuarial loss                | 24,817           | 7,430         |
| Expected return on plan assets           | (60,125)         | (49,779)      |
| Amortization of Prior Service Cost       | (21)             | -             |
| <b>Net periodic benefit cost</b>         | <b>111,664</b>   | <b>76,107</b> |
| Additional information:                  |                  |               |
| Increase (decrease) in minimum liability | (106,357)        | 191,430       |

##### Assumptions

|  | Pension Benefits |        |
|--|------------------|--------|
|  | 2010             | 2009   |
| Weighted-average assumptions used in computing ending obligations: |                  |        |
| Discount rate  | 5.50 %           | 5.50 % |
| Rate of compensation increase                                      | 4.00             | 4.00   |
| Weighted-average assumptions used in computing net cost:           |                  |        |
| Discount rate  | 5.50             | 7.25   |
| Rate of compensation increase                                      | 4.00             | 4.00   |
| Expected return on plan assets                                     | 7.75             | 7.75   |

The expected rate of return on plan assets was determined based on the average rate of earnings expected to be earned on the current and target asset categories.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 9. Employee Benefit Plans (Continued)

##### Plan Assets

The Association participates in a multiple employer pension plan called the Insurance Organizations Employees' Retirement Plan (the "Plan").

The asset allocation for the Plan at the end of the Association's fiscal year, and the ongoing target allocation, by asset category, follows:

| Asset Category    | Target       | As of              |   | As of              |   |
|-------------------|--------------|--------------------|---|--------------------|---|
|                   |              | September 30, 2010 |   | September 30, 2009 |   |
| Equity securities | 60 %         | 58                 | % | 67                 | % |
| Debt securities   | 40           | 37                 |   | 27                 |   |
| Cash              | -            | 5                  |   | 6                  |   |
| <b>Total</b>      | <b>100 %</b> | <b>100 %</b>       |   | <b>100 %</b>       |   |

The Plan's investment policy is set by the Trustees of the Insurance Organization Pension Trust. Plan assets are invested to generate a long-term investment return (net of management and administrative fees) that exceeds the Consumer Price Index ("CPI") inflation rate by at least 5.0%. Long-term investment results are measured over rolling periods of eight to ten years. During 2009, the Trustees adopted a strategy to gradually move from a 75% equity / 25% debt securities allocation to a 60% equity / 40% debt securities allocation over a period of 1-2 years by investing new contributions to the plan in accordance with the new target allocation rather than moving existing funds.

In addition to pension benefits, the Association and the NCIUA provide certain health care and life insurance ("postretirement") benefits for retired employees. The costs and accrued liabilities associated with these benefits are allocated between the two entities in the same proportions as for the pension plan. Retirees are eligible to continue medical coverage on a contributory basis and will continue to receive the same basic life insurance until age 65 at which time the coverage will be reduced to \$5,000. Current employees and part-time employees who work at least 20 hours per week can become eligible for these life insurance benefits by retiring after meeting the age and service requirements of age 55 and 10 years of service. Medical benefit eligibility requirements are age 50 with 65 points (age plus service) or age 65 with 5 years of service. Spouses and dependent children of these retirees are also eligible to participate.

For measurement purposes, the discount rate used in 2010 in determining the accumulated postretirement benefit obligation was 5.5%, and the health care cost-trend rate was 9.0%, decreasing 0.5% per year to an ultimate rate of 5.0% in 2018. A nonvested accumulated postretirement benefit obligation of \$457,813 existed at September 30, 2010.

A nonvested pension projected benefit obligation and accumulated benefit obligation of \$74,028 and \$64,859, respectively, existed at September 30, 2010. A nonvested pension projected benefit obligation and accumulated benefit obligation of \$63,114 and \$65,705, respectively, existed at September 30, 2009.

The Medicare Prescription Drug Improvement and Modernization Act of 2003 was enacted during 2003 (the "Act"). The Act creates Medicare Part D which could have some effect on the Association's obligations under the postretirement health plan. Measures of the accumulated postretirement benefit obligation and the net periodic benefit cost recorded in these statutory financial statements do not reflect any changes brought about by the Act because the employer is unable to conclude whether the benefits provided by the plan are actuarially equivalent to Medicare Part D under the Act.

## **North Carolina Joint Underwriting Association**

### **Notes to Statutory Financial Statements**

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#### **Note 9. Employee Benefit Plans (Continued)**

##### **Cash Flows**

The Company expects to contribute approximately \$74,000 to its pension plan and approximately \$11,000 to its other postretirement benefit plan in fiscal year 2011.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in fiscal years:

| Year      | Pension Plan |
|-----------|--------------|
| 2011      | \$ 44,247    |
| 2012      | 49,499       |
| 2013      | 53,642       |
| 2014      | 57,419       |
| 2015      | 61,333       |
| 2016-2020 | 382,187      |

##### **Defined Contribution Plan**

The Association also offers an Employee Savings Plan to employees working at least 1,000 hours in a year. This plan is offered through a multiple-employer arrangement with the Association matching 100% of employee contributions up to 6% of the employee's earnings. The Association's expense for the years ended September 30, 2010 and 2009 was \$35,463 and \$34,432, respectively.

#### **Note 10. Fair Values of Financial Instruments**

Due to their short-term maturity or settlement, the fair values of cash and short-term investments, balances due on account from insureds and others, payables, and remittances and items not allocated approximate their carrying amounts as reflected in the statutory statements of admitted assets, liabilities and members' surplus. The fair value and amortized cost of bonds is estimated based on quoted market prices if available, and if not, fair values are estimated using present value or other valuation techniques. These techniques are significantly affected by our assumptions, including discount rates and estimates of future cash flows. Potential taxes and other transaction costs have not been considered in estimating fair values. The fair value and amortized cost of bonds approximated \$33,189,000 and \$31,175,000, respectively, and at September 30, 2009. The fair value and amortized cost of bonds approximated \$25,595,000 and \$24,586,000, respectively, at September 30, 2009.

The Association has not historically maintained financial instruments for trading purposes.

## North Carolina Joint Underwriting Association

### Notes to Statutory Financial Statements

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#### Note 11. Reinsurance Agreement

The Association, along with the North Carolina Insurance Underwriting Association (collectively, the "Associations"), has entered into joint property catastrophe excess of loss reinsurance agreements on a per risk basis covering risks located in North Carolina, as defined by the Association, in order to reduce its exposure to wind losses that may result from a catastrophic event. For 2010, in the event of a named storm, the Associations retain the first \$1.4 billion of loss and cede approximately 69.1% of losses in 6 layers excess of \$1.4 billion up through \$4.0 billion of losses. Losses in a \$300 million layer excess of \$4.0 billion are 100% ceded through a catastrophe recovery charge. All losses above \$4.3 billion are retained by the Associations. The Associations have also purchased reinstatement premium protection where the Associations cede approximately 88.4% in two \$500 million layers excess of \$1.6 billion up to \$2.6 billion. The reinsurers' responsibility for losses from all loss occurrences during the term of the contract cannot exceed \$4.8 billion. The 2010 reinsurance agreements cover the period from May 1, 2010 to May 1, 2011. The Associations also purchased similar agreements in recent years with lower coverage amounts.

During 2009, the Associations entered into agreements related to a principal at-risk variable rate note program under which a special purpose entity has issued \$200 million of notes (commonly referred to as "catastrophe bonds"), which mature in May 2011 unless extended under the terms of the notes, to support the Associations' reinsurance program at levels in excess of the Associations' traditional reinsurance program. Because these agreements contain an indemnity trigger, the Associations have accounted for transactions related to this program as ceded reinsurance. The result of this program is that 27% of losses in the layer of \$700 million excess of \$2.6 billion is reinsured leaving the Associations with 10.05% retention in this layer.

During 2010, the Associations entered into agreements related to another principal at-risk variable rate note program under which a special purpose entity has issued \$305 million of notes (catastrophe bonds), which mature in May 2013 unless extended under the terms of the notes, to support the Associations' reinsurance program at levels in excess of the Associations' traditional reinsurance program. The notes were issued in tranches of \$200 million and \$105 million. In May 2011, the \$200 million notes from 2011 will move down one layer to cover the May 2009 notes that will be expiring. Because these agreements contain an indemnity trigger, the Associations have accounted for transactions related to this program as ceded reinsurance. The result of this program is that 43.6% of the 49.7% of losses in the layer of \$700 million in excess of \$3.3 billion is reinsured leaving the Associations with 6.1% retention in this layer.

There were no reimbursed losses and loss adjustment expenses for the years ended September 30, 2010 and 2009.

For the excess of loss coverages described above, the Associations are charged a provisional premium, which may be adjusted in accordance with a formula included in the reinsurance agreement for each excess layer if the limits of insurance in force (total insured value) increases or decreases by an average of greater than 10%. The effect of reinsurance on premiums written and earned during the years ended September 30, 2010 and 2009 is as follows:

|                     | 2010                 |                      | 2009                 |                      |
|---------------------|----------------------|----------------------|----------------------|----------------------|
|                     | Written              | Earned               | Written              | Earned               |
| Direct              | \$ 25,922,170        | \$ 25,735,045        | \$ 25,666,085        | \$ 26,484,603        |
| Ceded               | (8,258,062)          | (8,258,062)          | (7,789,451)          | (7,789,451)          |
| <b>Net premiums</b> | <b>\$ 17,664,108</b> | <b>\$ 17,476,983</b> | <b>\$ 17,876,634</b> | <b>\$ 18,695,152</b> |

## **North Carolina Joint Underwriting Association**

### **Notes to Statutory Financial Statements**

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#### **Note 11. Reinsurance Agreement (Continued)**

Reinsurance contracts do not relieve the Associations of their primary obligation to policyholders and failure of the reinsurers to discharge their obligations could result in losses to the Associations. The Associations, with the assistance of their reinsurance intermediary, regularly evaluate the financial condition of their reinsurers and monitor concentrations of credit risk related to their reinsurance activities.

No credit losses resulted from ceded reinsurance activities during the years ended September 30, 2010 or 2009.

There is no unsecured reinsurance recoverable on paid and unpaid losses and loss adjustment expenses for individual reinsurers whose balances exceeded 3% of the Association's surplus as of September 30, 2010 or 2009.

The maximum amount of return commission which would have been due reinsurers if either the reinsurers or the Association had canceled the Association's reinsurance as of the end of the years ended September 30, 2010 or 2009 is not material.

#### **Note 12. Subsequent Events**

Events or transactions that occur after the Statements of Admitted Assets, Liabilities, Capital and Surplus date, but before statutory financial statements are complete and available to be issued, are reviewed by the Association to determine if they are to be recognized.

All of the effects of subsequent events that provide additional evidence about conditions that existed at the Statements of Admitted Assets, Liabilities, Capital and Surplus date, including the estimates inherent in the process of preparing the statutory financial statements, are recognized in the statutory financial statements. The Association does not recognize subsequent events that provide evidence about conditions that did not exist at the Statements of Admitted Assets, Liabilities, Capital and Surplus date but arose after, but before the statutory financial statements are available to be issued. In some cases, nonrecognized subsequent events are disclosed to keep the statutory financial statements from being misleading.

In early 2011, the Internal Revenue Service notified the Association that it intended to conduct an examination of the Association's 2008 exempt organization tax return. As of March 3, 2011, the IRS audit has begun and remains underway. Management is unable to express an opinion about the ultimate outcome of the examination.

The Company has evaluated subsequent events through March 3, 2011 which is the date that the statutory financial statements were available to be issued.