North Carolina Insurance Underwriting Association

Statutory Financial Statements
With Independent Auditor's Report Thereon
September 30, 2011 and 2010

Contents

McGladrey

Independent Auditor's Report

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

We have audited the accompanying statutory statements of admitted assets, liabilities and members' surplus of North Carolina Insurance Underwriting Association (the "Association") as of September 30, 2011 and 2010, 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 statutory financial statements, the Association prepared these statutory financial statements using accounting practices prescribed or permitted by the North Carolina Department of Insurance, 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, 2011 and 2010, 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 North Carolina Department of Insurance. 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, 2011 and 2010, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note 1.

The Association's loss exposure net of reinsurance has increased very rapidly in recent years due to several factors. A very severe hurricane could produce losses that would require the Association's member companies to be assessed up to $1 billion in nonrecoupable assessments, after which the Association, pursuant to applicable provisions of North Carolina law, could impose an annual catastrophe recovery charge on residential and commercial property insurance policyholders statewide, not to exceed 10 percent of each policy's annual premium until all losses and expenses related to the storm (or series of storms) are paid. The ability of the Association to pay claims to insureds from such storms and nonrecoupable assessments and the timing of those payments could depend upon the timing of receipts from reinsurers and member companies and any catastrophe recovery charges imposed on policyholders statewide. The Association does not currently have a method of financing these losses on a short-term basis if policyholder assessments are imposed.

McGladrey & Pullen, LLP

Raleigh, North Carolina
April 30, 2012

North Carolina Insurance Underwriting Association

Statutory Statements Of Admitted Assets, Liabilities, and Members' Surplus
September 30, 2011 And 2010

	2011	2010
Admitted Assets		
Cash and short-term investments	**$ 256,704,534**	$ 251,783,046
Bonds (Note 3)	**661,234,089**	649,123,179
Cash and invested assets	**917,938,623**	900,906,225
Interest income due and accrued	**5,213,833**	4,863,494
Net due from North Carolina Joint Underwriting Association (Note 5)	**-**	1,420,357
Other receivables, net	**14,508,372**	386,662
Data processing equipment, at cost less accumulated depreciation of $740,009 in 2011; $587,935 in 2010	**72,124**	64,903
Total admitted assets	**$ 937,732,952**	$ 907,641,641
Liabilities and Members' Surplus		
Liabilities		
Unpaid losses (Note 4)	**$ 114,277,489**	$ 8,187,895
Unpaid loss adjustment expenses (Note 4)	**10,318,687**	919,750
Unearned premiums	**163,276,355**	162,818,528
Remittances and items not allocated	**10,787,961**	9,645,178
Net due to North Carolina Joint Underwriting Association (Note 5)	**195,509**	-
Accounts payable and accrued expenses (Note 9)	**6,866,999**	7,562,444
Total liabilities	**305,723,000**	189,133,795
Commitments and contingencies (Notes 2, 6 and 7)		
Members' surplus	**632,009,952**	718,507,846
Total liabilities and members' surplus	**$ 937,732,952**	$ 907,641,641

See Notes To Statutory Financial Statements.

North Carolina Insurance Underwriting Association

Statutory Statements Of Operations and Changes In Members' Surplus
Years Ended September 30, 2011 And 2010

	2011	2010
Direct premiums written	**$ 303,724,266**	$ 303,258,229
Change in unearned premiums	**(457,828)**	(1,060,973)
Ceded reinsurance premiums	**(198,078,041)**	(174,234,853)
	105,188,397	127,962,403
Underwriting expenses (Notes 4, 6 and 9):		
Losses incurred	**164,804,305**	12,823,444
Loss adjustment expenses incurred	**14,821,516**	1,754,501
Commissions	**39,146,303**	39,193,203
Salaries and benefits	**2,703,026**	2,526,513
8714946.19	**8,714,946**	8,561,059
Other underwriting expenses	**2,149,928**	1,897,640
Total underwriting deductions	**232,340,024**	66,756,359
Net underwriting (loss) gain	**(127,151,627)**	61,206,044
Other income	**505,152**	-
Investment income:		
Interest income	**23,580,210**	24,297,987
Net (loss) income	**(103,066,264)**	85,504,031
Members' surplus:		
Beginning	**718,507,846**	649,608,419
Distributions to members (Note 8)	**(20,052,821)**	(36,591,044)
Assessments of members (Note 8)	**36,414,962**	19,954,877
Change in additional minimum pension liability (Note 9)	**(127,557)**	238,994
Change in nonadmitted assets	**333,786**	(207,431)
Ending	**$ 632,009,952**	$ 718,507,846

See Notes To Statutory Financial Statements.

North Carolina Insurance Underwriting Association

Statutory Statements Of Cash Flows
Years Ended September 30, 2011 And 2010

	2011	2010
Cash Flows From Operations		
Premiums collected net of reinsurance	**$ 92,714,623**	$ 129,127,219
Losses and loss adjustment expenses paid	**(64,137,290)**	(9,996,868)
Net interest income	**23,229,871**	24,060,415
Underwriting expenses paid	**(51,136,947)**	(49,269,825)
Net cash provided by operations	**670,257**	93,920,941
Cash Flows From Investments		
Cost of long-term investments acquired:		
Bonds and other debt instruments	**(254,802,357)**	(248,297,975)
Proceeds from investments sold, matured or repaid:		
Bonds and other debt instruments	**242,691,447**	159,256,027
Net cash used in investments	**(12,110,910)**	(89,041,948)
Cash Flows From Financing and Miscellaneous Sources		
Member assessments	**36,414,962**	28,371,973
Member distributions	**(20,052,821)**	(36,591,044)
Net cash (used in) provided by financing and miscellaneous sources	**16,362,141**	(8,219,071)
Net increase (decrease) in cash and short-term investments	**4,921,488**	(3,340,078)
Cash And Short-Term Investments:		
Beginning	**251,783,046**	255,123,124
Ending	**$ 256,704,534**	$ 251,783,046

See Notes To Statutory Financial Statements.

Note 1. Nature Of Organization And Significant Accounting Policies

North Carolina Insurance Underwriting Association (the Association) was formed August 15, 1969 as an association of insurance companies (Members) mandated by North Carolina law. The Association is 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 the coastal areas of North Carolina when not obtainable in the public insurance market. The majority of the Association's policies are submitted by independent insurance agents, who remit premiums directly to the Association. In recent years the number of policies issued has increased substantially, resulting in greatly increased exposure levels.

The Association is administered by a Board of Directors and is subject to the supervision of the Commissioner of Insurance of the State of North Carolina. The Board of Directors consists of representatives of the Members, insurance agents appointed by the Commissioner, and public members also appointed by the Commissioner. The general 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 after 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 Federal 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.

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 an insurance company's domicile comprise a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). The more significant differences between NAIC practices (SAP) and GAAP are as follows:

- Investments in bonds and other debt instruments are generally reported at amortized cost, unless required to be reported at fair 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.

- For loan-backed and structured securities, if the Association determines that it intends to sell a security or no longer has 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.

- 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, whereas 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. Under GAAP, such costs, to the extent realizable, are 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 nonvested employees. Under GAAP, nonvested 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.

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.

The statements of cash flows do not reflect net amounts from investing activities and do not include reconciliations of net income to net cash from operations. In addition, the statements of cash flows include short-term investments with original maturities of one year or less while under GAAP, the statement of cash flows include securities with original maturities 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 such as 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 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.

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, 2011 and 2010, 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.

Data processing equipment: Data processing equipment is carried at cost less accumulated depreciation. The Association provides for depreciation on these assets using the straight-line method over three to five years. Depreciation expense was $153,108 and $149,058 for the years ended September 30, 2011 and 2010, respectively. Maintenance and repairs are charged to expense as incurred.

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

		2011		2010
Furniture and equipment, less accumulated depreciation of $740,009 in 2011 and $649,134 in 2010	**$**	**39,500**	$	127,456
Prepaid expenses		**136,479**		139,514
Accounts receivable, assessments		**17,810**		962
Insolvent member companies receivable		**(343,406)**		(83,763)
	$	**(149,617)**	$	184,169

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 of $153,108 and $137,003 at September 30, 2011 and 2010, respectively, is reflected in the statements of operations with a corresponding credit to 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.

Note 1. Nature Of Organization And Significant Accounting Policies (Continued)

Establishing liabilities for claims is subject to significant uncertainties that make reserve estimation difficult. 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 surplus.

Member participation: Each Member's participation in the Association’s operations during 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.

Premiums and related commissions: Premiums are earned over the periods covered by the policies on a daily pro-rata basis. 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. 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 written premium.

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. The Association’s tax-exempt status was examined by the Internal Revenue Service in 2011, and the Association’s exemption was reaffirmed.

Note 2. Significant Increased Exposure To Coastal Properties

As many insurers have lessened or ceased their voluntary writings of policies cover on North Carolina coastal properties over the past few years. As pricing of policies has become much less competitive for coverages in coastal areas, the Association has seen an unprecedented increase in the number of policies it writes, and therefore in its exposure. The Association currently estimates it has approximately $72 billion of exposure along the North Carolina coast.

Management estimates that a very severe hurricane could produce losses that would require the Association to assess amounts totaling several billion dollars. The ability of the Association to pay claims to insureds from such a storm and the timing of those payments would depend upon receipts of those assessments from the member companies.

The Association’s loss exposure net of reinsurance has increased very rapidly in recent years due to several factors. A very severe hurricane could produce losses that would require the Association’s member companies to be assessed up to $1 billion in nonrecoupable assessments, after which the Association, pursuant to applicable provisions of North Carolina law, could impose an annual catastrophe recovery charge on residential and commercial property insurance policyholders statewide, not to exceed 10 percent of each policy’s annual premium until all losses and expenses related to the storm (or series of storms) are paid. The ability of the Association to pay claims to insureds from such storms and nonrecoupable assessments and the timing of those payments could depend upon the timing of receipts from reinsurers and member companies and any catastrophe recovery charges imposed on policyholders statewide. The Association does not currently have a method of financing these losses on a short-term basis if policyholder assessments are imposed.

Note 3. Bonds

Amortized cost (admitted amount), aggregate fair value and gross unrealized gains and losses pertaining to the portfolio of bonds as of September 30, 2011 and 2010 are as follows:

	September 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U. S. Treasury obligations	$ 204,555,964	$ 14,032,631	$ (190,545)	$ 218,398,050
Federal agency obligations	326,368,671	17,476,322	(948,283)	$ 342,896,710
Federal agency mortgage-backed securities	121,316,144	6,277,895	(22,143)	127,571,896
Corporate debt securities	8,993,310	116,540	-	9,109,850
	$ 661,234,089	$ 37,903,388	$ (1,160,971)	$ 697,976,506

Note 3. Bonds (Continued)

	September 30, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U. S. Treasury obligations	$ 177,124,922	$ 10,338,618	$ -	$ 187,463,540
Federal agency obligations	378,908,574	18,809,492	(426,295)	$ 397,291,771
Federal agency mortgage-backed securities	84,096,373	4,681,041	-	88,777,414
Corporate debt securities	8,993,310	337,000	-	9,330,310
	$ 649,123,179	$ 34,166,152	$ (426,295)	$ 682,863,035

Amortized cost and aggregate fair value of bonds held as of September 30, 2011, 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	Fair Value
Amounts due in less than one year	$ 24,438,330	$ 24,691,400
Amounts due after one year through five years	289,969,509	299,537,735
Amounts due after five years through ten years	158,768,127	169,479,825
Amounts due after ten years	188,058,123	204,267,546
	$ 661,234,089	$ 697,976,506

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, 2011:

	12 Months or Less		**More than 12 Months**		**Total**	
	Fair Value	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
U.S. Treasury obligations	**$ 48,122,150**	**$ 190,545**	**$ -**	**$ -**	**$ 48,122,150**	**$ 190,545**
Federal agency obligations	**25,991,500**	**1,855**	**23,792,028**	**946,428**	**49,783,528**	**948,283**
Federal agency mortgage-backed securities	**1,681,566**	**22,143**	**-**	**-**	**1,681,566**	**22,143**
	$ 75,795,216	**$ 214,543**	**$ 23,792,028**	**$ 946,428**	**$ 99,587,244**	**$ 1,160,971**

Note 3. Bonds (Continued)

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	$ 53,408,825	$ 276,271	$ 24,588,432	$ 150,024	$ 77,997,257	$ 426,295

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.

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.

For 2011 and 2010, no securities were determined to be other than temporarily impaired.

Investment income, net of investment expenses, which are not material, for the fiscal years ending September 30, 2011 and 2010 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:

	2011	2010
Balance at October 1	**$ 9,107,645**	$ 4,526,568
Incurred related to:		
Current year	**180,617,903**	15,683,164
Prior years	**(992,082)**	(1,105,219)
Total incurred	**179,625,821**	14,577,945
Paid related to:		
Current year	**(57,016,542)**	(8,288,234)
Prior years	**(7,120,748)**	(1,708,634)
Total paid	**(64,137,290)**	(9,996,868)
Balance at September 30	**$ 124,596,176**	$ 9,107,645

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 reserves in 2011 and 2010 resulted from favorable development of claims on an overall basis. The significant increase in incurred losses for 2011 over 2010 was primarily the result of Hurricane Irene which hit the North Carolina coast in late August 2011.

The components of unpaid losses and loss adjustment expenses as of September 30, 2011 and 2010 are as follows:

	2011	2010
Unpaid losses:		
Case basis	**$ 69,957,414**	$ 3,195,832
Incurred but not reported	**44,320,075**	4,992,063
	114,277,489	8,187,895
Unpaid loss adjustment expenses:		
Case basis	**6,016,384**	334,992
Incurred but not reported	**4,302,303**	584,758
	10,318,687	919,750
	$ 124,596,176	$ 9,107,645

Note 5. Related Party Transactions

A related organization, North Carolina Joint Underwriting Association ("NCJUA"), shares the same headquarters 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 72 percent allocated to the Association and the remainder to NCJUA for the year ended September 30, 2011, and 71 percent allocated to the Association and remainder to NCJUA for the year ended September 30, 2010, except for certain other 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, 2011, the Association had a net payable to NCJUA of $195,509. At September 30, 2010, the Association had a net receivable from NCJUA of $1,420,357.

Note 6. Lease Commitments

The Association and NCJUA jointly rent home office facilities under an operating lease agreement, which expires in calendar year 2014. The Association was allocated 72 percent of the costs under this lease agreement in fiscal year 2011 and 71 percent of the costs under this lease in fiscal year 2010. The Association's allocated share of rent expense was $237,299 in 2011 and $242,548 in 2010.

The Association's share of the rent commitments, based on current cost sharing provisions with NCJUA, under the terms of operating lease agreements at September 30, 2011 is as follows:

Year Ending September 30,	Amount
2012	$ 384,192
2013	383,236
2014	392,364
2015	59,331
Thereafter	-
	$ 1,219,123

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 litigation. Management does not believe the ultimate disposition of any current litigation in which the Association is involved will 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 involved.

A membership assessment totaling $36,414,962 and a membership distribution totaling $20,052,821 were made in fiscal year 2011. A membership assessment totaling $19,954,877 and a membership distribution totaling $36,591,044 were made in fiscal year 2010.

There were no admitted amounts due from Association members at September 30, 2011 or 2010.

Note 9. Employee Benefit Plans

The Association and the NCJUA 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 2011 and 2010, the Association is allocated 72 percent and 71%, respectively, of the costs and obligations associated with their participation in the plan under the current cost-sharing arrangement with the NCJUA.

The Association uses a September 30 measurement date for its plans. The following financial information on the plan is only the Associations’ allocated share.

Note 9. Employee Benefit Plans (Continued)

Obligations and Funded Status

	Pension Benefits	
	2011	2010
Changes in benefit obligations:		
Obligations at beginning of year	**$ 3,023,654**	$ 2,950,482
Service cost	**181,196**	190,165
Interest cost	**173,286**	169,715
Plan amendments	**-**	-
Participant contributions	**-**	-
Actuarial (gains) losses	**18,150**	(235,782)
Benefits paid	**(76,618)**	(92,921)
Change in cost sharing with NCJUA	**-**	-
Obligations at end of year	**3,319,668**	2,981,659
Changes in plan assets:		
Fair value of assets at beginning of year, primarily pooled separate accounts with insurance companies and mutual funds	**2,263,785**	1,867,377
Actual return on assets	**17,615**	191,783
Association contributions	**184,797**	266,105
Participant contributions	**-**	-
Benefits paid	**(76,618)**	(92,921)
Change in cost sharing with NCJUA	**-**	-
Fair value of assets at end of year, primarily pooled separate accounts with insurance companies and mutual funds	**2,389,579**	2,232,344
Funded status (plan assets less than benefit obligations) at end of years	**(930,089)**	(749,315)
Amounts not recognized on statutory statements of admitted assets, liabilities, and surplus before additional minimum pension liability:		
Unrecognized net loss	**735,756**	578,069
Prior service cost	**(427)**	(472)
Net amount recognized on statutory statements of admitted assets, liabilities, and surplus before additional minimum pension liability	**(194,760)**	(171,718)

Note 9. Employee Benefit Plans (Continued)

	Pension Benefits	
	2011	2010
Amounts recognized on statutory statements of admitted assets, liabilities, and surplus as:		
Accrued benefit cost	**$ (194,760)**	$ (171,718)
Adjustment to record to additional minimum liability	**(312,802)**	(208,287)
Net amount recognized on statutory statements of admitted assets, liabilities, and surplus	**$ (507,562)**	$ (380,005)
Aggregate accumulated benefit obligation for defined benefit pension plan	**$ 2,902,493**	$ 2,612,349
For pension plan with accumulated benefit obligation in excess of assets at September 30 of the respective years:		
Projected benefit obligation	**3,319,668**	2,981,659
Accumulated benefit obligation	**2,902,493**	2,612,349
Fair value of plan assets	**2,389,579**	2,232,344

Components of Net Periodic Benefit Cost and Additional Information

	Pension Benefits	
	2011	2010
Components of net periodic benefit cost:		
Service cost	**$ 181,196**	$ 190,165
Interest cost	**173,286**	169,715
Recognized actuarial loss	**27,501**	60,760
Expected return on plan assets	**(176,512)**	(147,202)
Amortization of prior service cost	**(52)**	(51)
Net periodic benefit cost	**$ 205,419**	$ 273,387
Additional information:		
Increase (decrease) in minimum liability	**$ 104,515**	$ (260,388)

Assumptions

	Pension Benefits	
	2011	2010
Weighted-average assumptions used in computing ending obligations:		
Discount rate	**5.25%**	5.50%
Rate of compensation increase	**4.00**	4.00
Weighted-average assumptions used in computing net cost:		
Discount rate	**5.50**	5.50
Rate of compensation increase	**4.00**	4.00
Expected return on plan assets	**7.75**	7.75

Note 9. Employee Benefit Plans (Continued)

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.

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 September 30, 2011	As of September 30, 2010
Equity securities	**60**	**55 %**	58 %
Debt securities	**40**	**41**	37
Cash	**-**	**4**	5
Total	**100 %**	**100 %**	100 %

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.

A nonvested pension projected benefit obligation and accumulated benefit obligation of $102,205 and $72,446, respectively, existed at September 30, 2011. A nonvested pension projected benefit obligation and accumulated benefit obligation of $181,241 and $158,792, respectively, existed at September 30, 2010.

In addition to pension benefits, the Association and the NCJUA 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 2011 in determining the accumulated postretirement benefit obligation was 5.5%, and the health care cost-trend rate was 8.5 percent decreasing 0.5 percent per year to an ultimate rate of 5.0 percent in 2018. A nonvested accumulated postretirement benefit obligation of $1,038,041 existed at September 30, 2011.

Note 9. Employee Benefit Plans (Continued)

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 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.

Cash Flows

The Association expects to contribute approximately $181,000 to its pension plan and approximately $23,000 to its other postretirement benefit plan in fiscal year 2012.

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

Year	Pension Plan
2012	106,966
2013	125,554
2014	136,907
2015	148,050
2016	159,671
2017-2021	1,005,223

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 percent of employee contributions up to 6 percent of the employee's earnings. The Association's expense for the years ended September 30, 2011 and 2010 was $83,813 and $86,823, 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 surplus. The fair value and amortized cost of bonds are estimated based on quoted market prices if available, and it 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 transactions costs have not been considered in estimating fair values. The fair value and amortized cost of bonds approximated $697,977,000 and $661,234,000, respectively, at September 30, 2011. The fair value and amortized cost of bonds approximated $682,863,000 and $649,123,000, respectively, at September 30, 2010.

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

Note 10. Fair Values Of Financial Instruments (Continued)

Fair value is based on an exit price, which is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Association employs a hierarchal disclosure framework which prioritizes and ranks the level of market price observability used in measuring financial instruments at fair value. Market price observability is affected by a number of factors, including the type of instrument and the characteristics specific to the instrument. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of market price observability and a lesser degree of judgment in measuring fair value.

The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of fair value hierarchy are as follows:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that the Association has the ability to access at the measurement date.

Level 2 – Valuations derived from inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, such as:

a) Quoted prices for similar assets or liabilities in active markets.

b) Quoted prices for identical or similar assets or liabilities in markets that are not active.

c) Inputs other than quoted prices that are observable for the asset or liability.

d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Valuations are derived from techniques that require significant unobservable inputs. The unobservable inputs reflect the Association's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

The Association held no investments that were required to be recorded at fair value as of September 30, 2011.

Note 11. Reinsurance Agreements

The Association, along with the North Carolina Joint Underwriting Association (collectively, the Associations), has entered into joint property catastrophe excess of loss reinsurance agreements 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 2011, in the event of a covered catastrophic event, the Associations retain the first $1.3 billion of loss and cede approximately 83.3 percent of losses in 7 layers excess of $1.3 billion up through $4.0 billion of losses, including the coverage offered by the multi-year excess of loss reinsurance agreements discussed in the following two paragraphs. Losses in a $300 million layer excess of $4.0 billion are 100 percent ceded through a catastrophe recovery charge. All losses above $4.3 billion are retained by the Associations. There is one mandatory restatement for the coverage for each of the layers of $690 million in excess of $1.6 billion and $687 million in excess of $2.29 billion at potential total premiums of approximately $132.5 million. The Associations have purchased reinstatement premium protection that pays for up to $92.1million of the mandatory reinstatement premiums. The reinsurers' and catastrophe bond investors responsibility for losses from all loss occurrences during the term of the contract cannot exceed $3.73 billion. The 2011 reinsurance agreements cover the period from May 1, 2011 to May 1, 2012. The Associations also purchased similar agreements in recent years with lower coverage amounts.

Note 11. Reinsurance Agreements (Continued)

During 2010, the Association entered into multi-year excess of loss reinsurance agreements with a reinsurer, who in turn implemented a catastrophe bond program and related agreements with respect to a principal at-risk variable rate note program under which the reinsurer has retroceded such risk to a special purpose entity, who has issued $305 million of notes (catastrophe bonds), which mature in May 2013 unless extended under the terms of the notes. The notes were issued in tranches of $200 million and $105 million. Because the Associations' reinsurance contracts with the reinsurer contain an indemnity trigger, the Associations have account for the transactions as ceded reinsurance.

During 2011, the Association entered into multi-year excess of loss reinsurance agreements with a reinsurer, who retroceded such risk to an existing special purpose entity, who issued $202 million of notes (catastrophe bonds), which mature in May 2014 unless extended under the terms of the notes. The notes were issued in tranches of $70 million and $132 million. Because the Associations' reinsurance contracts with the reinsurer contain an indemnity trigger, the Associations have accounted for the transactions as ceded reinsurance. The 2010 and 2011 programs cover a varying percentage of losses between $3 billion and $3.3 billion.

There were no reimbursed losses and loss adjustment expenses for the years ended September 30, 2011 and 2010.

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, 2011 and 2010 is as follows:

	2011		2010	
	Written	**Earned**	Written	Earned
Direct	**$ 303,724,266**	**$ 303,266,438**	$ 303,258,229	$ 302,197,256
Ceded	**(198,078,041)**	**(198,078,041)**	(174,234,853)	(174,234,853)
Net premiums	**$ 105,646,225**	**$ 105,188,397**	$ 129,023,376	$ 127,962,403

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, 2011 or 2010.

There is no unsecured reinsurance recoverable on paid and unpaid losses and loss adjustment expenses for individual reinsurers whose balances exceeded 3 percent of the Association’s surplus as of September 30, 2011 or 2010.

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, 2011 or 2010 is not material.

Note 13. 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.

The Association has evaluated subsequent events through April 30, 2012, which is the date the statutory financial statements were available to be issued.

The Association established its provision for loss and loss adjustment expense related to Hurricane Irene as of September 30, 2011 based on information available at that time. Subsequent to year-end, the Association has experienced loss and loss adjustment activity related to Hurricane Irene that is substantially less than what was expected at September 30, 2011. The Association has not yet updated its actuarial analysis considering the impact of this favorable experience, however based on the significant drop in Hurricane Irene related activity, the Association is expecting material favorable development in Hurricane Irene related reserves during 2012.