

North Carolina Insurance Underwriting Association

Statutory Financial Statements
With Independent Auditor's Report Thereon
December 31, 2012

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Independent Auditor's Report

The Board of Directors
North Carolina Insurance Underwriting Association
Cary, North Carolina

Report on the Financial Statements

We have audited the accompanying statutory financial statements of North Carolina Insurance Underwriting Association, which comprise the statutory statement of admitted assets, liabilities, and surplus of North Carolina Insurance Underwriting Association as of December 31, 2012, and the related statutory statements of operations and changes in surplus, and cash flows for the three months then ended and the related notes to the statutory financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these statutory financial statements in accordance with the accounting practices prescribed or permitted by the North Carolina Department of Insurance; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of statutory financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these statutory financial statements based on our audit. We conducted our audit 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 statutory financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statutory financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the statutory financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the statutory financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the statutory financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

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

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles" paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of North Carolina Insurance Underwriting Association as of December 31, 2012, or the results of its operations or its cash flows thereof for the three months then ended.

Opinion on Regulatory Basis of Accounting

In our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of North Carolina Insurance Underwriting Association as of December 31, 2012, and the results of its operations and its cash flows for the three months then ended, on the basis of accounting described in Note 1.

McGladrey LLP

Raleigh, North Carolina
October 21, 2013

North Carolina Insurance Underwriting Association

**Statutory Statement Of Admitted Assets, Liabilities, And Surplus
December 31, 2012**

Admitted Assets

Cash And Short-Term Investments	\$ 235,711,369
Bonds, at prescribed value	<u>676,909,021</u>
Cash and invested assets	912,620,390
Interest income due and accrued	4,694,176
Net due from North Carolina Joint Underwriting Association	223,889
Premiums receivables	18,542,471
Data processing equipment, at cost less accumulated depreciation of \$547,324	<u>246,640</u>
Total admitted assets	<u>\$ 936,327,566</u>

Liabilities And Surplus

Liabilities	
Unpaid losses	\$ 9,996,254
Unpaid loss adjustment expenses	1,059,879
Deferred revenue	172,471,968
Advance premiums	8,133,713
Accounts payable and accrued expenses	<u>8,537,409</u>
Total liabilities	200,199,223
Commitments And Contingencies	
Surplus	<u>736,128,343</u>
Total liabilities and surplus	<u>\$ 936,327,566</u>

See Notes To Statutory Financial Statements.

North Carolina Insurance Underwriting Association

**Statutory Statement Of Operations And Changes In Surplus
For The Three Months Ended December 31, 2012**

Direct premiums written	\$ 75,129,479
Change in unearned premiums	10,393,084
Ceded reinsurance premiums	<u>(47,822,183)</u>
	<u>37,700,380</u>
Underwriting expenses:	
Losses incurred	3,652,157
Loss adjustment expenses incurred	651,479
Commissions	9,410,515
Salaries and benefits	963,055
Insurance taxes, licenses and fees	2,132,920
Other underwriting expenses	<u>720,370</u>
Total underwriting deductions	<u>17,530,496</u>
Net underwriting gain	20,169,884
Other income	67,828
Investment income:	
Interest income	<u>2,927,264</u>
Net income	<u>23,164,976</u>
Surplus:	
Beginning	713,054,021
Change in additional minimum pension liability	(58,641)
Change in nonadmitted assets	<u>(32,013)</u>
Ending	<u><u>\$ 736,128,343</u></u>

See Notes To Statutory Financial Statements.

North Carolina Insurance Underwriting Association

Statutory Statement Of Cash Flows

For The Three Months Ended December 31, 2012

Cash Flows From Operations	
Premiums collected net of reinsurance	\$ 30,877,487
Losses and loss adjustment expenses paid	(5,123,871)
Net interest income	5,570,646
Underwriting expenses paid	(16,992,985)
Net cash provided by operations	<u>14,331,277</u>
 Cash Flows From Investments	
Cost of long-term investments acquired:	
Bonds and other debt instruments	(90,150,765)
Proceeds from investments sold, matured or repaid:	
Bonds and other debt instruments	59,322,617
Net cash used in investments	<u>(30,828,148)</u>
 Cash Flows From Financing And Miscellaneous Sources	
Net cash used in by financing and miscellaneous sources	<u>-</u>
 Net decrease in cash and short-term investments	 (16,496,871)
 Cash And Short-Term Investments:	
Beginning	<u>252,208,240</u>
 Ending	<u><u>\$ 235,711,369</u></u>

See Notes To Statutory Financial Statements.

North Carolina Insurance Underwriting Association

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 Association, also known as the Coastal Property Insurance Pool, is a tax exempt insurer of last resort created by law to provide an adequate market for essential property in the beach and coastal areas of North Carolina. The Association is an association of insurance companies authorized to write essential property insurance coverage in North Carolina. The majority of the Association's policies are submitted by North Carolina licensed agents, who remit new business premiums directly to the Association.

As the Association only writes business in the State of North Carolina, it has a geographic concentration of policies written, which results in increased loss exposure for severe storms. Under North Carolina law, all insurers who are authorized to write and engaged in writing essential property insurance in North Carolina on a direct basis, except town and county mutual insurance associations, certain assessable mutual companies and certain insurers who only write insurance on property exempted from taxation under the North Carolina General Statutes, are required to participate in the Association. In the event that losses and expenses of the NCIUA exceed available surplus, reinsurance and other sources of funding, the Association is authorized to issue a non-recoupable assessment upon its Member Insurers not to exceed one billion dollars (\$1,000,000,000) for losses incurred from any event or series of events that occur in a given calendar year, regardless of when such assessments are actually levied on or collected from Member Insurers. Each Member Insurer of the Association must participate in non-recoupable assessments levied by the Association in the proportion that its net direct premium written in North Carolina during the preceding calendar year for residential and commercial properties outside of the beach and coastal areas bears to the aggregate net direct premiums written in North Carolina during the preceding calendar year for residential and commercial properties outside of the beach and coastal areas by all Member Insurers. Any assessment levied on Member Insurers by the Association (as ordered by the Association's Board of Directors) generally is due from the Member Insurers within thirty days of assessment.

The Association is administered by a Board of Directors and is subject to the regulation 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.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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

Loss reserves: The Association estimates loss and loss adjustment expenses after consultation with the Association's independent actuary. These amounts are recorded net of estimated recoveries 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 estimated 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. The Association, through discussions with the North Carolina Department of Insurance (NCDI), will be changing its fiscal year to a more traditional calendar year-end. In order to effect this change, the NCDI has approved the Association's preparing a three months ended December 31, 2012 financial statement. Going forward, the Association will be preparing its statutory financial statements on a traditional calendar year end. Except as previously noted, there is no deviation from the NAIC Accounting Practices and Procedures Manual in the Association's financial statements.

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 under GAAP.
- 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 another than temporary impairment is determined to have occurred.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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

- 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 with credit losses reported in operations and non-credit reported as a component of equity, whereas for statutory purposes the total other-than-temporary impairment loss is reported in operations.
- 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 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 projected 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.
- 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 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 three months 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.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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

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 another-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.

Accrued investment income: The Association nonadmits investment income due and accrued if amounts are over 90 days past due. As of December 31, 2012, 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 \$29,917 for the three months ended December 31, 2012. 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:

Furniture and equipment, less accumulated depreciation	
of \$766,042 in 2012	\$ 123,879
Prepaid expenses	90,838
Accounts receivable, assessments	17,811
Insolvent member companies receivable	(343,406)
	<u>\$ (110,878)</u>

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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

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 \$7,205 for the three months ended December 31, 2012 is reflected in the statements of operations.

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.

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 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 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.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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

Upcoming Accounting Pronouncements: In 2012, the NAIC adopted SSAP No. 102, *Accounting for Pension, a Replacement of SSAP 89*. SSAP 102 establishes financial accounting and reporting standards for an insurer that offers pension benefits to its employees. This statement supersedes the guidance in SSAP No. 89, *Accounting for Pensions, A Replacement of SSAP No. 89* and incorporates the guidance in Interpretation 99-26: *Offsetting Pension Assets and Liabilities*, Interpretation 01-16: *Measurement Date for SSAP No. 8 Actuarial Valuations*, Interpretation 04-03: *Clarification for Calculating the Additional Minimum Pension Liability under SSAP No. 89* and Interpretation 04-12: *Determining the Classification and Benefit Attribution Method for a Cash Balance Pension Plan*. This SSAP also modifies Interpretation 04-17: *Impact of Medicare Modernization on Postretirement Benefits* to remove reference to pensions as this interpretation only addresses postretirement benefits other than pensions. This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2013 (transition date) with early adoption permitted.

Prior to SSAP 102, the accounting for pensions looked to the accumulative benefit obligation, whereas, under SSAP 102, if the projected benefit obligation (considering both vested and nonvested participants) exceeds the fair value of plan assets, the employer shall recognize in its statement of financial position a liability that equals the unfunded projected benefit obligation. If the fair value of plan assets exceeds the projected benefit obligation, the employer shall recognize in its statement of financial position an asset that equals the overfunded projected benefit obligation. This prepaid asset resulting from the excess of the fair value of plan assets over the projected benefit obligation shall be non-admitted. Due to the potential impact to surplus as a result of adoption, reporting entities may elect an optional plan to bring the impact into surplus over a period of time. The Company is currently evaluating the potential impact, if any, the adoption of SSAP No.102 will have on their statutory financial statements.

In 2012, the NAIC adopted SSAP No. 92, *Accounting for Postretirement Benefits Other Than Pensions, A Replacement of SSAP No. 14*. SSAP 92 applies to all postretirement benefits expected to be provided by an employer to current and former employees (including retirees, disabled employees, and other former employees who are expected to receive postretirement benefits), their beneficiaries, and covered dependents, pursuant to the terms of an employer's undertaking to provide those benefits. This statement supersedes the guidance in SSAP No. 14, *Postretirement Plans Other Than Pensions*, and incorporates the guidance in Interpretation 99-26: *Offsetting Pension Assets and Liabilities*, and Interpretation 01-16: *Measurement Date for SSAP No. 8 Actuarial Valuations*.

This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2013 (transition date) with early adoption permitted. The status for each plan shall be measured as the difference between the fair value of plan assets and the accumulated postretirement benefit obligation (considering both vested and non-vested employees) as it is defined in this statement. Gains or losses, prior service costs or credits (including prior service costs for non-vested participants), and remaining transition assets or obligations (collectively referred to as "unrecognized items") from prior application of SSAP No. 14 that have not yet been included in net periodic benefit cost as of December 31, 2012 shall be recognized as components of the ending balance of unassigned funds (surplus), net of tax, as of January 1, 2013, or later if an alternative method of adoption is elected. After recognition, the full unfunded or overfunded status of the plan shall be reflected within the financial statements. Any prepaid asset resulting from an overfunded plan shall be non-admitted. Due to the potential impact to surplus as a result of adoption, reporting entities may elect an optional plan to bring the impact into surplus over a period of time. The Company is currently evaluating the potential impact, if any, the adoption of SSAP No. 92 will have on their statutory financial statements.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 2. Significant Increased Exposure To Coastal Properties

The Association lacks empirical means to verify why more insureds have requested coverage from the plan in recent years. However, the Association experienced double digit growth during fiscal 2012 in both policy issued count and exposure growth. Policy issued count increased from 209,782 to 236,202 for a 13 percent increase and aggregate exposure increased from 72 billion to 81 billion, for a 13 percent increase in 2012.

In the event of losses and expenses to the Association exceeding available surplus, reinsurance, and other sources of funding of Association losses, the Association is authorized to issue a non-recoupable assessment upon its members in accordance with its Plan of Operation. Member assessments shall not exceed one billion dollars (\$1,000,000,000) for losses incurred from any event or series of events that occur in a given calendar year, regardless of when such assessments are actually levied on or collected from member companies. Any assessment levied on Member Insurers by the Association (as ordered by the Association's Board of Directors) generally is due from the Member Insurers within thirty days of assessment.

When the Association knows that it has incurred losses and loss expenses in a particular calendar year that will exceed the combination of available surplus, reinsurance, and other sources of funding, including permissible member company assessments, then the Association shall immediately give notice to the Commissioner that a deficit event has occurred. The Association can enter into any financing arrangements for the purpose of financing a deficit, provided that the pledge of catastrophe recovery charge amounts under such financing agreements shall not result in the actual levying of any catastrophe recovery charge until after the Association has incurred a deficit and until after the Commissioner has approved implementation of the Association's catastrophe recovery charge plan.

Note 3. Bonds

Amortized cost (admitted amount), aggregate fair value and gross unrealized gains and losses pertaining to the portfolio of bonds as of December 31, 2012 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
U. S. Treasury obligations	\$ 243,684,237	\$ 18,097,433	\$ (459,070)	\$ 261,322,600
Federal agency obligations	321,392,091	18,208,088	(56,127)	\$ 339,544,052
Federal agency mortgage- backed securities	89,102,870	5,242,983	(112,658)	94,233,195
Inflation Bond	22,729,823	-	(193,062)	22,536,761
	<u>\$ 676,909,021</u>	<u>\$ 41,548,504</u>	<u>\$ (820,917)</u>	<u>\$ 717,636,608</u>

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 3. Bonds (Continued)

Amortized cost and aggregate fair value of bonds held as of December 31, 2012, 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	\$ 76,472,860	\$ 76,784,521
Amounts due after one year through five years	398,274,285	417,130,179
Amounts due after five years through ten years	120,252,864	139,435,707
Amounts due after ten years	81,909,012	84,286,201
	<u>\$ 676,909,021</u>	<u>\$ 717,636,608</u>

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 December 31, 2012:

	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	\$ 25,038,000	\$ 459,070	\$ -	\$ -	\$ 25,038,000	\$ 459,070
Federal agency obligations	-	-	22,855,136	56,127	22,855,136	56,127
Federal agency mortgage-backed securities	296,774	5,263	7,006,608	107,395	7,303,382	112,658
Inflation Bonds	-	-	22,536,761	193,062	22,536,761	193,062
	<u>\$ 25,334,774</u>	<u>\$ 464,333</u>	<u>\$ 52,398,505</u>	<u>\$ 356,584</u>	<u>\$ 77,733,279</u>	<u>\$ 820,917</u>

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

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 3. Bonds (Continued)

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 the three months ended 2012, no securities were determined to be other than temporarily impaired.

Investment income, net of investment expenses, for the three months ending December 31, 2012, 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 for the three months ended December 31, 2012 is summarized as follows:

Balance at October 1	<u>\$ 11,876,368</u>
Incurred related to:	
Current period	4,303,636
Prior periods	-
Total incurred	<u>4,303,636</u>
Paid related to:	
Current period	(1,788,604)
Prior periods	(3,335,267)
Total paid	<u>(5,123,871)</u>
Balance at December 31	<u><u>\$ 11,056,133</u></u>

As a result of the events of the three months ended December 31, 2012, the Company did not adjust expected ultimates related to prior periods.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 4. Reserve for Losses and Loss Adjustment Expenses

The components of unpaid losses and loss adjustment expenses as of December 31, 2012 are as follows:

Unpaid losses:

Case basis	\$ 4,090,221
Incurred but not reported	5,906,033
	<u>9,996,254</u>

Unpaid loss adjustment expenses:

Case basis	407,092
Incurred but not reported	652,787
	<u>1,059,879</u>
	<u>\$ 11,056,133</u>

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 Association and NCJUA. Shared expenses are allocated between the two parties with 71 percent allocated to the Association and the remainder to NCJUA for the three months ended December 31, 2012, except for certain expenses (furniture, computer hardware, board fees, programming, etc.) 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 December 31, 2012, the Association had a net receivable from NCJUA of \$223,889.

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 71 percent of the costs under this lease agreement during the three months ended December 31, 2012. The Association's allocated share of rent expense was \$60,619 in the three months ended December 31, 2012. The Association also leases certain equipment jointly with NCJUA.

The Association's share of the rent commitments, based on current cost sharing provisions with NCJUA, under the terms of operating lease agreements at December 31, 2012 is as follows:

Calendar Year Ending December 31,	Amount
2013	\$ 396,803
2014	337,956
2015	5,160
	<u>\$ 739,919</u>

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 6. Lease Commitments (Continued)

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

There were no admitted amounts due or processed from Association members at December 31, 2012.

Note 9. Employee Benefit Plans

Pension Benefits: The Association and NCJUA participate in a multiple employer pension plan called the Insurance Organizations Employees' Retirement Plan (the Plan). 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 the three months ended December 31, 2012, the Association is allocated 71 percent of the costs and obligations associated with their participation in the plan under the current cost-sharing arrangement with NCJUA.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 9. Employee Benefit Plans (Continued)

The Association uses a December 31 measurement date for its plans. The following financial information on the plan is only the Association's allocated share.

Obligations And Funded Status	Pension Benefits
Changes in benefit obligations:	
Obligations at beginning of period	\$ 4,294,567
Service cost	59,188
Interest cost	44,183
Actuarial (gains) losses	-
Benefits paid	(27,348)
Change in cost sharing with NCIUA	(117,659)
Obligations at end of period	4,252,931
Changes in plan assets:	
Fair value of assets at beginning of period, primarily pooled separate accounts with insurance companies and mutual funds	2,990,909
Actual return on assets	46,930
Association contributions	-
Benefits paid	(27,348)
Change in cost sharing with NCIUA	(81,943)
Fair value of assets at end of period, primarily pooled separate accounts with insurance companies and mutual funds	2,928,548
Funded status (plan assets less than benefit obligations) at end of period	(1,324,383)
Amounts not recognized on statutory statements of admitted assets, liabilities, and members' surplus before additional minimum pension liability:	
Unrecognized net loss	1,016,861
Prior service cost	(357)
Net amount recognized on statutory statements of admitted assets, liabilities, and surplus before additional minimum pension liability	\$ (307,879)
Change in additional minimum pension liability admitted assets, liabilities, and surplus as:	
Accrued benefit cost	(307,879)
Adjustment to record to additional minimum liability	(462,838)
Net amount recognized on statutory statements of admitted assets, liabilities, and surplus	\$ (770,717)
Aggregate accumulated benefit obligation for defined benefit pension plan	\$ 3,699,265
For pension plan with accumulated benefit obligation in excess of assets at December 31 of the respective period:	
Projected benefit obligation	4,252,931
Accumulated benefit obligation	3,699,265
Fair value of plan assets	2,928,548

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 9. Employee Benefit Plans (Continued)

Components Of Net Periodic Benefit Cost And Additional Information

	Pension Benefits
Components of net periodic benefit cost:	
Service cost	\$ 59,188
Interest cost	44,183
Recognized actuarial loss	16,142
Expected return on plan assets	(51,148)
Amortization of prior service cost	(13)
Net periodic benefit cost	\$ 68,352
Additional information:	
Increase (decrease) in minimum liability	\$ 58,641

Assumptions	Pension Benefits
Weighted-average assumptions used in computing ending obligations:	
Discount rate	4.25 %
Rate of compensation increase	4.00
Weighted-average assumptions used in computing net cost:	
Discount rate	4.25
Rate of compensation increase	4.00
Expected return on plan assets	7.25

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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 members of the Plan participate in 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.

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 December 31, 2012
Equity securities	60	60 %
Debt securities	40	38
Cash	-	2
Total	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 percent. 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 \$102,148 and \$75,509, respectively, existed at December 31, 2012.

Postretirement Benefits: In addition to pension benefits, the Association and 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. Based on the number of years of service, retirees are eligible to continue medical coverage on a contributory or noncontributory 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 ten years of service. Medical benefit eligibility requirements are age 50 with 65 points (age plus service) or age 65 with five years of service. Spouses and dependent children of these retirees are also eligible to participate.

For measurement purposes, the discount rate used in 2012 in determining the accumulated postretirement benefit obligation was 4.25 percent, and the health care cost-trend rate was 8.0 percent decreasing 0.5 percent per year to an ultimate rate of 5.0 percent in 2018. A vested accumulated postretirement benefit obligation of \$1,906,032 existed at December 31, 2012. A nonvested accumulated postretirement benefit obligation of \$1,315,390 existed at December 31, 2012.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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 \$220,000 to its pension plan and approximately \$57,000 to its other postretirement benefit plan in 2013.

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

Year	Pension Plan
2013	129,096
2014	141,345
2015	154,248
2016	166,888
2017	179,617
2018-2022	1,141,241

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 three months ended December 31, 2012 was \$22,476.

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 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 transactions costs have not been considered in estimating fair values. The fair value and amortized cost of bonds approximated \$717,637,000 and \$676,909,000, respectively, at December 31, 2012.

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

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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 hierarchical 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 December 31, 2012.

Note 11. Reinsurance Agreements

The Association, along with NCJUA (collectively, the Associations), has entered into joint property catastrophe excess of loss reinsurance agreements covering risks located in North Carolina. For 2012, in the event of a covered catastrophic event, the Associations and its members retain the first \$1.6 billion of losses (\$600 million retained earnings and \$1 billion assessment to members) and cede the remaining losses in 5 layers in excess of \$1.6 billion up through \$3.8 billion of losses. The first \$375 million layer excess of \$1.6 billion is aggregate coverage which consists of single and multi-year coverage and no reinstatement premiums are required. The next three layers total \$992 million and are in excess of \$1.975 billion and are per occurrence coverage with the Associations retaining the reinstatement premiums. The final layer is \$832 million in excess of \$2.967 billion. This layer consists of \$57 million excess of loss coverage, \$507 million of catastrophe bond coverage and \$268 million of catastrophe recovery charges. The 2012 reinsurance agreements cover the period from May 1, 2012 to May 1, 2013.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

Note 11. Reinsurance Agreements (Continued)

During 2010, the Associations 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 accounted for the transactions as ceded reinsurance.

During 2011, the Associations 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 catastrophe bonds are in the final layer of the 2012 risk financing program.

There were no reimbursed losses and loss adjustment expenses for the three months ended December 31, 2012.

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 ten percent. The effect of reinsurance on the Association premiums written and earned during the three months ended December 31, 2012 is as follows:

	Written	Earned
Direct	\$ 75,129,479	\$ 85,522,563
Ceded	(47,822,183)	(47,822,183)
Net premiums	\$ 27,307,296	\$ 37,700,380

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 three months ended December 31, 2012.

There is no unsecured reinsurance recoverable on paid and unpaid losses and loss adjustment expenses for individual reinsurers whose balances exceeded three percent of the Association's surplus as of December 31, 2012.

The Association has not received a ceding commission as part of its reinsurance arrangements. Therefore, upon cancellation no return commission will be due.

North Carolina Insurance Underwriting Association

Notes To Statutory Financial Statements

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.

The Association has evaluated subsequent events through October 21, 2013, which is the date the statutory financial statements were available to be issued.

