# CALIFORNIA EARTHQUAKE AUTHORITY

Financial Statements
December 31, 2011 and 2010

*With Independent Auditors' Report Thereon*

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LARSON & ROSENBERGER LLP
CERTIFIED PUBLIC ACCOUNTANTS

**Independent Auditors' Report**

To the Governing Board
California Earthquake Authority

We have audited the accompanying balance sheets of the California Earthquake Authority (CEA) as of December 31, 2011 and 2010, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the CEA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the California Earthquake Authority as of December 31, 2011 and 2010, and the changes in its financial position and cash flows for the years then ended in conformity with generally accepted accounting principles in the United States of America.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 9 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

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Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying schedules of participating insurer capital contributions, participating insurer premiums written, participating insurer unearned premiums, participating insurer commissions and participating insurer operating costs, on pages 25 to 29, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The schedules of participating insurer capital contributions, participating insurer premiums written, participating insurer unearned premiums, participating insurer commissions and participating insurer operating costs are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Larson & Rosenberger LLP

Glendale, California
August 20, 2012

# CALIFORNIA EARTHQUAKE AUTHORITY

Management's Discussion and Analysis

## History and Financing

This discussion provides an assessment by management of the financial position, revenues, expenses, changes in net assets, cash flows and liquidity of the California Earthquake Authority (CEA). Readers are encouraged to consider the information presented in conjunction with the financial statements as a whole, which follow Management's Discussion and Analysis.

Following the unprecedented losses from the 1994 Northridge earthquake, many insurance companies either stopped or severely restricted selling new homeowners' insurance policies in California. The insurer response was largely due to state law that requires insurers to offer earthquake insurance when selling or renewing residential property insurance.

In September 1996, legislation to create the CEA was approved by the California State Legislature. On November 26, 1996, the State of California Insurance Commissioner certified that all statutory conditions necessary for the CEA to become operational had been met, and the CEA began writing earthquake policies on December 1, 1996. The CEA is overseen by a three member Governing Board consisting of the Governor, the Treasurer, and the Insurance Commissioner or their designees. The Speaker of the Assembly and the Chairperson of the Senate Rules Committee or their designees serve on the Governing Board as nonvoting members. The Governing Board establishes premium rates, subject to the prior approval of the Insurance Commissioner. The Governing Board is advised by an 11 member advisory panel, consisting of members of the public, consumers and insurance industry representatives.

The CEA uses its available capital (net assets) to leverage approximately $9.8 billion in claims-paying capacity at December 31, 2011. The CEA's claims-paying capacity is determined from the CEA's available capital, risk-transfer coverage, available letters of credit, debt, and post-event prospective participating insurance company assessments. The CEA derives its capital from participating insurer capital contributions and from increases in net assets generated from the sale of earthquake insurance policies. The CEA is exempt from federal income tax and from state insurance-premium tax. California Insurance Code section 10089.44 provides, in pertinent part, that "… premiums collected by the authority shall be exempt from collection of the state's insurance premium tax, and the amount of tax foregone by the state shall be considered for all purposes a contribution by the state and its citizens to the capital and operating revenues of the authority."

The CEA has approximately 821,000 policyholders at December 31, 2011, most of whom insure single-family dwellings through the CEA. The CEA offers a basic residential earthquake policy to homeowners, which includes coverage for the insured dwelling and limited coverage for contents and loss-of-use if the residence is uninhabitable due to an earthquake. The CEA also offers policies to condominium unit owners and renters. For an additional premium, CEA policyholders can significantly increase insured limits on contents and for loss-of-use, and homeowners can lower their CEA policy deductible from 15 percent to 10 percent.

The CEA employs contract employees and employees subject to civil-service provisions. By law, the number of employees subject to civil-service provisions is limited to 25. Because of its limited staff size, the CEA uses an extensive network of contract vendors to perform functions on behalf of the CEA.

### Using the Report

While the CEA is an instrumentality of the state, the State of California's General Fund is not liable for CEA claims, losses, or other liabilities. However, the CEA meets the definition of a governmental organization, as defined by accounting principles generally accepted in the United States of America. The CEA's financial statements for the years ended December 31, 2011 and 2010 have been prepared using accounting standards applicable to governmental entities. This financial report consists of three financial statements with accompanying notes. The balance sheets, prepared on the accrual basis of accounting, include all assets, liabilities and net assets of the CEA. The statements of revenues, expenses, and changes in net assets, also prepared on the accrual basis, take into account all revenues and expenses for the CEA regardless of when cash is received or paid. The statements of cash flows reflect the actual cash receipts and disbursements for a specified period of time.

### Condensed Balance Sheets

The CEA's assets, liabilities and net assets as of December 31 are summarized as follows:

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| **Assets** | | | |
| Cash and investments | $ 4,508,924,403 | $ 4,273,041,274 | $ 4,002,726,319 |
| Premium receivable, net | 41,893,958 | 49,595,737 | 52,838,052 |
| Deferred policy acquisition costs | 41,619,480 | 40,674,396 | 40,154,994 |
| Other assets | 106,409,943 | 18,697,215 | 22,519,031 |
| Total assets | $ 4,698,847,784 | $ 4,382,008,622 | $ 4,118,238,396 |
| **Liabilities and Net Assets** | | | |
| Unearned premiums | $ 309,899,331 | $ 302,862,221 | $ 298,994,745 |
| Revenue bonds payable | 157,500,000 | 189,000,000 | 220,500,000 |
| Other liabilities | 10,913,051 | 8,207,794 | 8,503,359 |
| Total liabilities | 478,312,382 | 500,070,015 | 527,998,104 |
| Net assets: | | | |
| Restricted, expendable | 205,889,564 | 168,559,583 | 133,264,871 |
| Unrestricted | 4,014,645,838 | 3,713,379,024 | 3,456,975,421 |
| Total net assets | 4,220,535,402 | 3,881,938,607 | 3,590,240,292 |
| Total liabilities and net assets | $ 4,698,847,784 | $ 4,382,008,622 | $ 4,118,238,396 |

## Condensed Balance Sheets (Continued)

### *Assets*

Total assets grew $316.8 million (7%) in 2011 and $263.8 million (6%) in 2010. The 2011 and 2010 increases were primarily due to an increase in net assets of $338.6 million and $291.7 million, respectively. Cash and investments grew $235.9 million (6%) and $270.3 million (7%), in 2011 and 2010, respectively. Investments are managed by external managers under the guidance of the CEA. U.S. Treasuries, short-term investments and cash-equivalent securities comprise 100% of the CEA's investment portfolio.

Premium receivable balances decreased $7.7 million (-16%) and decreased $3.2 million (-6%) in 2011 and 2010, respectively. The 2011 decrease in premium receivables was due to the CEA receiving a larger portion of weekly premiums remitted by the CEA participating insurers in the last week of the year than in the last week of the previous year. The 2010 decrease in premium receivables was due to the normalization of this balance as compared to the 2009 balance, which was higher than usual because of the implementation of a new data system at the end of 2008.

Deferred policy acquisition costs, consisting of unearned participating insurer commissions and operating costs, are deferred and amortized ratably over the terms of the underlying policies. Deferred policy acquisition costs increased $0.9 million (2%) in 2011, which corresponds with the increase in policies that were unearned at the end of 2011. Deferred policy acquisition costs increased $0.5 million (1%) in 2010 that corresponds with the increase in policies that were unearned at the end of 2010. The operating cost reimbursement rate during 2011 and 2010 was the same at 3.43%.

The 2011 increase in other assets of $87.7 million (469%) was due to a combination of a security receivable of $68.5 million, a reinsurance premium deposit of $5.0 million, and prepaid reinsurance premium of $2.5 million. The security receivable was from an investment that matured on Saturday, December 31, 2011. The proceeds from the matured investment were received on Monday, January 2, 2012, when the bond-market opened. The 2010 decrease in other assets of $3.8 million was the net effect of an $8.2 million reduction in interest receivable, a $2.9 increase in capital contributions receivable, and a $1.7 million increase in risk-capital surcharges receivable.

### *Liabilities*

Unearned premiums represent the pro rata portion of the premiums written related to the remaining term of policies in force. Unearned premiums increased $7.0 million (2%) and increased $3.9 million (1%) in 2011 and 2010, respectively. The 2011 increase was due to the increase in premiums written by the end of 2011. The 2010 increase was due to the increase in premiums written by the end of 2010.

Revenue bonds payable decreased by $31.5 million (-17%) in 2011 resulting from the annual 10% principal reduction payment. The bonds were initially issued in June 2006, totaling $315 million. The revenue bonds bear interest at a fixed rate of 6.196% and mature in 2016 requiring annual 10% principal reduction payments.

Other liabilities include claims and claim expense reserves, which are not significant since California has not suffered a major earthquake during the CEA's existence. Other liabilities in 2011 increased $2.7 million (33%) in 2011 largely due to an accrued reinsurance premium expense of $1.7 million. Other liabilities remained at relatively the same amount for 2010 and 2009 with a decrease of $0.3 million (-3.5%) in 2010. The main reason for the decrease in 2010 was due to revenue bond interest payable decreasing as the outstanding principle decreased, causing the interest to decrease as well.

### Condensed Balance Sheets (Continued)

#### *Net Assets*

The CEA classifies its net assets into two components, restricted-expendable and unrestricted net assets. Restricted net assets include the net assets of the Earthquake Loss Mitigation Fund (Mitigation Fund), unspent bond proceeds restricted for payment of claims as defined in the debt agreements offset by underlying debt, funds held for debt service by the revenue bond trustee, and investment income earned on the bond proceeds restricted as pledged revenue for debt service. The Mitigation Fund was created by statute and related funds must be used solely for the establishment and operation of earthquake mitigation programs. The remaining net assets of the CEA are classified as unrestricted. The CEA's net assets grew $338.6 million (9%) and $291.7 million (8%) in 2011 and 2010, respectively. The 2011 increase was comprised of the underwriting profit of $275.0 million, premium tax contributions from the State of California of $14.4 million, and the increase in contributed capital of $20.8 million. The 2010 increase was comprised primarily of an underwriting profit of $249.3 million and premium tax contributions from the State of California of $13.9 million.

### Condensed Statements of Revenue, Expenses, and Changes in Net Assets

The CEA's operating results are presented in the following table:

| | 2011 | % | 2010 | % | 2009 | % |
|---|---|---|---|---|---|---|
| Underwriting income: | | | | | | |
| Premium written | $ 612,830,953 | 100% | $ 603,127,689 | 100% | $ 585,520,749 | 100% |
| Less premium ceded – reinsurance | (200,622,675) | | (221,788,128) | | (194,697,154) | |
| Net premium written | 412,208,278 | 67% | 381,339,561 | 63% | 390,823,595 | 67% |
| Change in net unearned premiums | (7,037,110) | | (3,867,476) | | 4,433,465 | |
| Net premium earned | 405,171,168 | 66% | 377,472,085 | 63% | 395,257,060 | 68% |
| Expenses: | | | | | | |
| Claims and claim expense | 299,164 | | 75,036 | | 137,637 | |
| Mitigation fund expenses | 343,570 | | 424,711 | | 376,472 | |
| Other underwriting expenses | 129,532,169 | | 127,677,823 | | 136,168,302 | |
| Total expenses | 130,174,903 | 21% | 128,177,570 | 21% | 136,682,411 | 23% |
| Underwriting profit | 274,996,265 | 45% | 249,294,515 | 41% | 258,574,649 | 44% |
| Net investment income | 27,893,141 | | 22,486,654 | | 10,864,785 | |
| Capital contributions | 20,772,000 | | 5,470,000 | | - | |
| Other income | 14,935,389 | | 14,447,146 | | 25,450,791 | |
| Increase in net assets | 338,596,795 | 55% | 291,698,315 | 48% | 294,890,225 | 50% |
| Net assets, beginning of year | 3,881,938,607 | | 3,590,240,292 | | 3,295,350,067 | |
| Net assets, end of year | $ 4,220,535,402 | | $ 3,881,938,607 | | $ 3,590,240,292 | |

**Condensed Statements of Revenue, Expenses, and Changes in Net Assets (Continued)**

The increase in net assets was $338.6 million in 2011, which resulted in a net profit margin of 55%, and $291.7 million in 2010, which resulted in a net profit margin of 48%. Net investment income increased $5.4 million (24%) in 2011. The increase was largely due to a $13.7 million increase in the change of unrealized investment gains on U.S. Treasuries and a decrease of $8.9 million in investment income. Net investment income increased $11.6 million (107%) in 2010. The increase was largely due to a $25.6 million decrease in the change of unrealized investment gain on U.S. Treasuries and a decrease of $15.2 million in investment income. The CEA's net premiums written increased $30.8 million (8%) in 2011 and decreased $9.5 million (-2.4%) in 2010. The 2011 increase is due to a $9.7 million growth in written premiums and a decrease in premiums ceded of $22.9 million. The 2010 decrease is due to a $17.6 million growth in written premiums while premiums ceded for reinsurance grew $27.1 million (14%).

The variance in the change in unearned premiums decreased $3.2 million and decreased $8.3 million in 2011 and 2010, respectively. The 2011 variance is due to an increase in unearned premium caused by a slight increase in premiums for policies not effective at the end of 2011. The 2010 variance is due to an increase in unearned premium caused by a slight increase in premiums for policies not effective at the end of 2010.

In 2011 and 2010, the CEA's claims and claim expenses were essentially zero due to California not experiencing any significant earthquakes.

In 2011, the increase in other underwriting expense of $2.1 million (2%) was largely due to a $0.9 million increase in participating insurer commissions and operating expense, and a $0.5 million increase in pro forma premium taxes. In 2010, the decrease in other underwriting expense of $8.5 million (-6%) was due to a $0.8 million increase in participating insurer commissions and operating expense, and an $11.1 million decrease in pro forma premium taxes. The decrease in pro forma premium taxes resulted from the 2009 adjustment for an error in the calculation of the pro forma premium taxes from the CEA's inception through 2008.

2009 adjustment to pro forma premium taxes:

| | (In Millions) |
|---|---|
| Inception - 1998 | $ 4.5 |
| 1999 | 1.2 |
| 2000 | .6 |
| 2001 | .4 |
| 2002 | .3 |
| 2003 | .3 |
| 2004 | .6 |
| 2005 | 1.0 |
| 2006 | .1 |
| 2007 | .8 |
| 2008 | 1.6 |
| Total | $ 11.4 |

Capital contributions increased $15.3 million and $5.5 million in 2011 and 2010, respectively. The 2011 increase was due to Nationwide Insurance Company joining the CEA as a participating insurer as of November 2011. The 2010 increase was due to an additional contribution from State Farm Insurance Company for additional earthquake insurance exposure transferred to the CEA during the year.

Other income remained relatively flat in 2011 and 2010.

**Condensed Statements of Cash Flows**

Primary sources of cash included cash flows from operations and capital contributions received from participating insurers. The primary use of cash was for operating expenses, repayment of debt, and the purchase of short-term and long-term investment securities.

The cash flows of the CEA are summarized as follows:

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Net cash provided by operating activities | $ 300,100,166 | $ 268,777,962 | $ 328,499,565 |
| Net cash used in noncapital financing activities | (31,011,209) | (30,961,093) | (31,104,301) |
| Net cash provided by capital and related financing activities | 6,572,406 | 1,818,807 | 43,332,709 |
| Net cash used in investing activities | (211,457,391) | (198,332,217) | (397,870,084) |
| Net increase (decrease) in cash and cash equivalents | 64,203,972 | 41,303,459 | (57,142,111) |
| Cash and cash equivalents, beginning of year | 96,456,862 | 55,153,403 | 112,295,514 |
| Cash and cash equivalents, end of year | $ 160,660,834 | $ 96,456,862 | $ 55,153,403 |

Cash from operating activities increased $31.3 million (12%) in 2011 and decreased $59.7 million (-18%) in 2010. The 2011 increase resulted from an increase in cash received from premiums of $15.9 million and a decrease in payments for reinsurance of $15.3 million. The 2010 decrease resulted from an increase in payments for reinsurance of $56.8 million and an increase in payments for operating expenses of $3.3 million.

Cash used in non-capital financing activities for 2011 and 2010 is a result of the CEA annual principal reduction payment of $31.5 million for its outstanding revenue bonds.

The $4.8 million (261%) change in cash provided by capital and related financing activities for 2011 was a result of $4.0 million in capital contribution installments received from Nationwide Insurance Company and the $0.7 million increase in purchases of equipment during 2011 as compared to 2010. The $41.5 million (-96%) change in cash provided by capital and related financing activities for 2010 was a result of a decrease of $41.0 million in capital contribution installments receivable due to Safeco making its final capital contribution and the $0.5 million increase in purchases of equipment during 2010 as compared to 2009.

The change in cash used in investing activities for 2011 was $13.1 million (7%) and reflects the CEA's decision to continue to prudently extend the duration of its portfolio as a result of the lagging economy, continued all-time low Treasury rates, and the Federal Reserve's postponement of any monetary tightening through the remainder of 2013 and possibly longer. The change in cash used in investing activities in 2010 was $199.5 million and was a result of the investment philosophy to gradually transition the CEA's investment portfolio from securities maturing in less than 90 days, which are classified as cash-equivalent securities, to short-term and long-term investments. The CEA slowed the transition of cash equivalent securities to longer-term securities in 2010 because of the all-time low federal funds rate and the possible increase in interest rates. In addition, because of the flatness in the shorter portion of the Treasury bond yield curve, and relatively low spreads for CEA-permitted security types other than Treasuries, management did not foresee a benefit to increase the duration of the CEA's portfolio at that time.

## Liquidity

The CEA maintains a highly liquid investment portfolio in order to be able to quickly pay claims in the event of a large earthquake. As of December 31, 2011, 26.68% of the portfolio was scheduled to mature in 90 days or less, securities maturing between 91 days and one year accounted for 36.15% of the portfolio, while securities maturing between one to five years accounted for the remaining 37.17% of the portfolio, with a total portfolio modified duration of less than one year. Based on earthquake modelers' results of analyzing the CEA's portfolio, management believes the CEA has sufficient liquidity to meet its obligations as they become due resulting from an earthquake or series of earthquakes. The probability of an earthquake or series of earthquakes occurring that would deplete CEA's liquidity and the associated claims-paying capacity is estimated to be 0.17% in any one year. The CEA pays policyholder claims from its claims-paying capacity. The following depicts the CEA's claims-paying capacity in effect as of December 31, 2011, in millions of dollars:

| | | |
|---|---|---|
| CEA capital available for claims | $ | 4,048 |
| Risk transfer financial products | | 3,050 |
| Revenue bonds | | 317 |
| Post-earthquake industry assessments (2nd Layer) | | 1,558 |
| Post-earthquake industry assessments (New Layer) | | 804 |
| Total | $ | 9,777 |

Under California's Insurance Code, the CEA has the ability to assess the participating insurers on a post-event basis if claim payments to policyholders reach certain levels, as defined. Additionally, the CEA is able to recover amounts under reinsurance contracts when policyholder claims reach certain defined levels.

## CALIFORNIA EARTHQUAKE AUTHORITY

Balance Sheets
As of December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| **Assets** | | |
| Cash and investments: | | |
| Cash and cash equivalents | $ 111,091,346 | $ 48,536,535 |
| Restricted cash | 49,569,488 | 47,920,327 |
| Restricted investments | 310,862,316 | 313,837,486 |
| Investments | 4,037,401,253 | 3,862,746,926 |
| Total cash and investments | 4,508,924,403 | 4,273,041,274 |
| Premiums receivable, net of allowance for doubtful accounts of $10,561,115 and $10,533,225 | 41,893,958 | 49,595,737 |
| Risk capital surcharge receivable | - | 1,700,000 |
| Capital contributions receivable | 17,310,000 | 3,190,830 |
| Interest receivable | 12,035,424 | 12,350,634 |
| Securities receivable | 68,858,008 | - |
| Prepaid reinsurance premiums | 2,546,102 | - |
| Deferred policy acquisition costs | 41,619,480 | 40,674,396 |
| Deposit with reinsurer | 5,029,836 | - |
| Equipment, net | 499,468 | 1,413,255 |
| Other assets | 131,105 | 42,496 |
| Total assets | $ 4,698,847,784 | $ 4,382,008,622 |
| **Liabilities and Net Assets** | | |
| Unearned premiums | $ 309,899,331 | $ 302,862,221 |
| Reinsurance premium payable | 1,676,612 | - |
| Securities payable | 871,423 | - |
| Revenue bond payable | 157,500,000 | 189,000,000 |
| Revenue bond interest payable | 4,858,088 | 5,829,705 |
| Accounts payable and accrued expenses | 3,506,928 | 2,378,089 |
| Total liabilities | 478,312,382 | 500,070,015 |
| Net assets: | | |
| Restricted, expendable | 205,889,564 | 168,559,583 |
| Unrestricted | 4,014,645,838 | 3,713,379,024 |
| Total net assets | 4,220,535,402 | 3,881,938,607 |
| Total liabilities and net assets | $ 4,698,847,784 | $ 4,382,008,622 |

*See accompanying notes to financial statements.*

## CALIFORNIA EARTHQUAKE AUTHORITY

Statements of Revenues, Expenses, and Changes in Net Assets
For the Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| Underwriting income: | | |
| Premiums written | $ 612,830,953 | $ 603,127,689 |
| Less premiums ceded | (200,622,675) | (221,788,128) |
| Net premiums written | 412,208,278 | 381,339,561 |
| Change in unearned premiums | (7,037,110) | (3,867,476) |
| Net premiums earned | 405,171,168 | 377,472,085 |
| Expenses: | | |
| Claims and claim expense | 299,164 | 75,036 |
| Participating insurer commissions | 60,623,577 | 59,970,221 |
| Participating insurer operating costs | 20,776,606 | 20,567,165 |
| Reinsurance broker commissions | 4,800,000 | 4,800,040 |
| Pro forma premium taxes | 14,446,598 | 13,908,239 |
| Financing expenses, net | 7,389,584 | 8,861,561 |
| Mitigation fund expenses | 343,570 | 424,711 |
| Other underwriting expenses | 21,495,804 | 19,570,597 |
| Total expenses | 130,174,903 | 128,177,570 |
| Underwriting profit | 274,996,265 | 249,294,515 |
| Net investment income | 27,893,141 | 22,486,654 |
| Other income | 488,791 | 538,907 |
| Contributed capital | 20,772,000 | 5,470,000 |
| State of California premium tax contribution | 14,446,598 | 13,908,239 |
| Increase in net assets | 338,596,795 | 291,698,315 |
| Net assets, beginning of year | 3,881,938,607 | 3,590,240,292 |
| Net assets, end of year | $ 4,220,535,402 | $ 3,881,938,607 |

*See accompanying notes to financial statements.*

## CALIFORNIA EARTHQUAKE AUTHORITY

Statements of Cash Flows
For the Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| **Cash Flows from Operating Activities:** | | |
| Cash received from premiums | $ 622,232,732 | $ 606,370,004 |
| Cash payments for premiums ceded - reinsurance | (206,522,001) | (223,488,128) |
| Cash payments for operating expenses | (115,610,565) | (114,103,914) |
| Net cash provided by operating activities | 300,100,166 | 268,777,962 |
| **Cash Flows from Noncapital Financing Activities:** | | |
| Repayment of revenue bonds | (31,500,000) | (31,500,000) |
| Other income | 488,791 | 538,907 |
| Net cash used in noncapital financing activities | (31,011,209) | (30,961,093) |
| **Cash Flows from Capital and Related Financing Activities:** | | |
| Capital contributions received from participating insurers | 6,652,830 | 2,593,189 |
| Acquisition of equipment | (80,424) | (774,382) |
| Net cash provided by capital and related financing activities | 6,572,406 | 1,818,807 |
| **Cash Flows from Investing Activities:** | | |
| Proceeds from maturities of investments | 3,692,317,795 | 4,120,423,879 |
| Purchases of investments | (3,951,135,195) | (4,389,600,177) |
| Net investment income | 47,360,009 | 70,844,081 |
| Net cash used in investing activities | (211,457,391) | (198,332,217) |
| Net increase in cash and cash equivalents | 64,203,972 | 41,303,459 |
| Cash and cash equivalents, beginning of year | 96,456,862 | 55,153,403 |
| Cash and cash equivalents, end of year | $ 160,660,834 | $ 96,456,862 |
| Reconciliation to statement of net assets: | | |
| Cash and cash equivalent | $ 111,091,346 | $ 48,536,535 |
| Restricted cash | 49,569,488 | 47,920,327 |
| | $ 160,660,834 | $ 96,456,862 |

*See accompanying notes to financial statements.*

## CALIFORNIA EARTHQUAKE AUTHORITY

Statements of Cash Flows (Continued)
For the Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| Reconciliation of operating income to net cash provided by operating activities: | | |
| Underwriting profit | $ 274,996,265 | $ 249,294,515 |
| Adjustments to reconcile underwriting profit to net cash provided by operating activities: | | |
| Depreciation on equipment | 994,212 | 901,265 |
| Pro forma premium tax expense | 14,446,598 | 13,908,239 |
| Changes in operating assets and liabilities: | | |
| Premiums receivable | 7,701,779 | 3,242,315 |
| Risk capital surcharge receivable | 1,700,000 | (1,700,000) |
| Deposit with reinsurer | (5,029,836) | - |
| Prepaid reinsurance premiums | (2,546,102) | - |
| Deferred policy acquisition costs | (945,084) | (519,402) |
| Other assets | (88,610) | 79,119 |
| Unearned premiums | 7,037,110 | 3,867,476 |
| Reinsurance premium payable | 1,676,612 | - |
| Revenue bond interest payable | (971,617) | (971,618) |
| Accounts payable and accrued expenses | 1,128,839 | 676,053 |
| Net cash provided by operating activities | $ 300,100,166 | $ 268,777,962 |

**Non-cash Investing, Capital and Financing Activities**

Net unrealized appreciation in the fair value of investments, which is included as a component of net investment income in the Statements of Revenues, Expenses and Changes in Net Assets, was $1.7 million and $(12.0) million in 2011 and 2010, respectively. Premium tax contributed by the State of California and recognized as a component of expense in the Statements of Revenues, Expenses, and Changes in Net Assets was $14.4 million and $13.9 million in 2011 and 2010, respectively.

*See accompanying notes to financial statements.*

## 1. Reporting Entity and Summary of Significant Accounting Policies

### *Reporting Entity*

The California Earthquake Authority (CEA) is a privately financed, publicly managed authority that provides insurance coverage for earthquake damage to residential property owners, condominium owners, mobile homeowners, and renters in the state of California. In September 1996, legislation to create the CEA was approved by the California State Legislature. On November 26, 1996, the State of California Insurance Commissioner certified that all statutory conditions necessary for the CEA to become operational had been met, and the CEA began writing earthquake policies on December 1, 1996. The CEA is overseen by a three member Governing Board consisting of the Governor, the Treasurer, and the Insurance Commissioner or their designees. The Speaker of the Assembly and the Chairperson of the Senate Rules Committee or their designees serve on the Governing Board as nonvoting members. The Governing Board is advised by an 11 member advisory panel, consisting of members of the public, consumers and insurance industry representatives.

CEA policies are sold to policyholders by participating insurers of the CEA. Insurance companies admitted to write residential property insurance in California and who elected to become participating members of the CEA sign Insurer Participation Agreements with the Insurance Commissioner and the CEA. Under these agreements, participating insurers act as independent contractor agents on behalf of the CEA by performing policy and claims services which include policy issuance, premium collection, and claims adjustment. Under the agreements, the CEA reimburses participating insurers for non-claims related costs incurred by these companies in servicing CEA policies. The operating cost reimbursement is 3.43% of written premium. The producer commission is equal to 10% of written premium of all new and renewal CEA policies. Additionally, participating insurers receive reimbursement for expenses associated with servicing CEA claims equal to 9% of paid claims. As of December 31, 2011, there are 21 participating insurers of which 16 insurers are writing CEA policies. Four participating insurers account for 76% of CEA’s written premiums.

The CEA has eligibility requirements that compel the CEA to issue and renew policies if the insured structure has no pre-existing, non-cosmetic earthquake damage and the policyholder has a companion policy of residential property insurance from a participating insurer.

In the event that a natural disaster program is enacted by Congress, the Advisory Panel is required to prepare a plan to dissolve the CEA or to conform the sections of the California Insurance Code regarding the CEA to the federal program and recommend an action plan to the CEA Governing Board and the California State Legislature.

### *Basis of Accounting*

While the CEA is an instrumentality of the state, the State of California's General Fund is not liable for CEA claims, losses, or other liabilities. However, the CEA meets the definition of a governmental organization, as defined by accounting principles generally accepted in the United States of America.

**1. Reporting Entity and Summary of Significant Accounting Policies (Continued)**

***Basis of Accounting (Continued)***

The CEA is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The CEA uses the economic resources measurement focus and the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Under this method, revenues are recorded when earned and expenses are recorded when incurred. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenue and expenses for the period, as well as the disclosure of contingent assets and liabilities. Actual results could differ from those estimates applied in the preparation of the accompanying financial statements.

In accordance with governmental accounting standards, the CEA applies all applicable statements issued by the Governmental Accounting Standards Board (GASB). The CEA applies all private-sector standards of accounting and financial reporting issued prior to November 30, 1989, unless those standards conflict with or contradict guidance of the GASB. In addition, the CEA has elected to apply pronouncements issued by the Financial Accounting Standards Board after November 30, 1989, unless those pronouncements conflict with or contradict guidance of the GASB.

***Revenue Recognition***

Premiums are recognized as earned on a pro rata basis over the policy contract period. All premium rates charged by the CEA must be approved by the State of California Insurance Commissioner before use. Unearned premiums represent amounts written which relate to coverage in future periods.

Premiums paid or accrued by the CEA under reinsurance agreements are accounted for as a reduction in the related premium revenue earned and amortized over the remaining reinsurance contract period. Unearned ceded premium is the pro rata portion of premiums ceded applicable to the unexpired period of reinsurance coverage.

***Cash and Cash Equivalents***

For purposes of the statement of cash flows, the CEA considers investments in certificates of deposit, U.S. treasuries, commercial paper, corporate bonds, and bankers' acceptances with original maturities of three months or less, to be cash equivalents. Restricted cash and cash equivalents are comprised of unspent bond proceeds, debt service sinking funds and monies transferred to the Earthquake Loss Mitigation Fund (Mitigation Fund).

## 1. Reporting Entity and Summary of Significant Accounting Policies (Continued)

### *Investments*

Investments consist primarily of certificates of deposit, U.S. treasuries, commercial paper, corporate bonds, and bankers' acceptances, as authorized by California Insurance Code (Code) section 10089.6. All investments are reported at fair value in the balance sheets. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, and is determined from published data provided by the exchanges, computerized pricing sources, securities custodians, and other authoritative sources. The CEA is permitted to invest in securities eligible in California Government Code section 16430. Restricted investments are comprised of unspent bond proceeds and monies transferred to the Mitigation Fund. The CEA intends to hold all investments to maturity unless there is an earthquake or series of earthquakes causing significant damage in California warranting the CEA's need to liquidate securities to pay policyholder claims.

### *Risk-Capital Surcharge*

Under California Insurance Code sec. 10089.16(d), effective July 1, 2008, the CEA Governing Board must calculate a risk-capital surcharge one year after the date that a new participating insurer first places or renews business into the CEA. The law provides that each annual risk-capital surcharge must equal the CEA's increased cost of providing or securing capacity to insure the new participant's excess earthquake-insurance risk. Safeco Insurance Company of America ("Safeco") was the first participating insurer to join the CEA after the risk-capital surcharge law took effect.

CEA staff analyzed Safeco's earthquake-insurance risk profile as of December 31, 2010, and determined that Safeco's business was no longer likely to produce greater losses for the CEA than would a book of existing CEA business of similar size. Therefore, the Governing Board at its June 2011 meeting determined that Safeco would not be required to pay an annual risk-capital surcharge going forward.

CEA staff analyzed Safeco's earthquake-insurance risk profile as of December 31, 2009, and determined that the addition of Safeco's business was more likely to produce losses for the CEA, or was likely to produce greater losses for the CEA, than would a book of existing CEA business of similar size. Therefore, the Governing Board required Safeco to pay a first annual risk-capital surcharge in the amount of $1,700,000. Since the intent of the risk-capital surcharge was to offset the increased cost to CEA of providing capacity to insure Safeco's excess earthquake-insurance risk for that one-year period, the CEA recorded the risk-capital surcharge as a reduction of premium ceded for reinsurance for the year ended December 31, 2010.

### *Deferred Policy Acquisition Costs*

Acquisition costs, consisting of participating insurer commissions and operating costs, are deferred and amortized over the terms of the underlying policies. Deferred acquisition costs are limited to the estimated recoverable value of such costs. The determination of estimated recoverable value gives effect to the premium to be earned, losses and loss adjustment expenses incurred, investment income to be earned, and certain other costs expected to be incurred as the premium is earned.

## 1. Reporting Entity and Summary of Significant Accounting Policies (Continued)

### *Claims and Claim Expense Reserves*

Reserves for insurance claims and claim adjustment expenses include the accumulation of case estimates for claims reported, claims incurred but not reported, and estimates of expenses for investigating and adjusting all incurred claims. The reserve is established at a level that management estimates to be sufficient to satisfy those claims. Estimates are revised as more information becomes available. Since the CEA's inception, there has not been a major earthquake. If a major California earthquake were to occur, there would be a significant increase in the reserve for claims and claim adjustment expenses. The CEA does not have any unpaid claims reported as of December 31, 2011.

If the CEA's Governing Board determines that the CEA's net assets, bond proceeds, additional participating insurer capital contributions and reinsurance proceeds are exhausted and that no source of additional funds is available to the CEA to pay policyholder claims, the Governing Board is required to develop a plan for approval by the State of California Insurance Commissioner to pay policyholder claims on a pro rata or installment basis. In such circumstances, the insurance code states that the commissioner shall order the CEA to cease renewing or accepting new earthquake insurance policies.

### *Participating Insurer Capital Contributions*

Each insurer that elected to participate in the CEA during its first year of operations was required to contribute as its share of the CEA's initial operating capital, an amount equal to $1,000,000,000 multiplied by the percentage representing that insurer's residential earthquake insurance market share as of January 1, 1994. Insurers that elect to participate in the CEA after December 1, 1996, are required to make an initial capital contribution calculated using their residential earthquake insurance market share as of January 1, 1994, or the latest date for which such market share information is available to the CEA, whichever contribution amount is greater. As of December 31, 2011, participating insurer capital contributions totaled $777 million and were 98% funded.

### *Participating Insurer Assessments*

The California Insurance Code (Code) states that, subject to certain maximum limits as set forth in the Code, the CEA has the power to make additional assessments of participating insurers in the event of a major California earthquake, subject to the approval of the State of California Insurance Commissioner. The CEA's ability to make certain additional assessments for the 1st industry assessment layer pertaining to the participating insurers expired December 1, 2008. However, during 2007 the CEA worked with the state legislature and participating insurers to establish a new industry assessment layer, which commenced on December 1, 2008. The maximum assessment amount of the new industry assessment layer as of December 31, 2011, was $804 million. The CEA continued to retain its 2nd industry assessment layer of $1.558 billion.

As of December 31, 2010, participating insurers have a cumulative residential property insurance market share of approximately 73% of the total residential property insurance market in California based on written premium. If participating insurers withdraw their participation in the CEA such that the cumulative residential property insurance market share is less than 65%, the Insurance Commissioner is required by law to make recommendations to the California Legislature for the continuation or termination of the CEA.

## 1. Reporting Entity and Summary of Significant Accounting Policies (Continued)

### *Net Assets*

The CEA classifies its net assets into two components, restricted-expendable and unrestricted net assets. Restricted net assets include the net assets of the Mitigation Fund, unspent bond proceeds restricted for payment of claims as defined in the debt agreements and funds held for debt service by the revenue bond trustee offset by underlying debt, and investment income earned on the bond proceeds restricted as pledged revenue for debt service.

### *Income Taxes*

In a private letter ruling dated November 8, 1996, the Internal Revenue Service determined the CEA to be an integral part of the State of California for federal income tax purposes. As such, the CEA is exempt from federal income tax.

### *State of California Premium Tax*

California Insurance Code section 10089.44 provides that "Notwithstanding any other provision of law, premiums collected by the authority shall be exempt from collection of the state's insurance premium tax, and the amount of tax foregone by the state shall be considered for all purposes a contribution by the state and its citizens to the capital and operating revenues of the authority." As a result, CEA is exempt from remitting state premium tax. State premium tax contributions were $14,446,598 and $13,908,239 for the years ended December 31, 2011 and 2010, respectively.

## 2. Cash and Investments

As of December 31, 2011 and 2010, the CEA had the following cash and investments:

| | December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Investment Maturities (in Years) | | | | | |
| | Less than 1 | 1-2 | 2-3 | 3-4 | 4-5 | Total |
| U.S. Treasuries | $ 2,305,085,737 | $ 907,398,231 | $ 293,038,782 | $ 271,924,587 | $ 202,472,254 | $ 3,979,919,591 |
| U.S. agencies | 387,678,169 | - | - | - | - | 387,678,169 |
| U.S. Gov't money market funds | 25,590,837 | - | - | - | - | 25,590,837 |
| Cash | 2,921,259 | - | - | - | - | 2,921,259 |
| Commercial paper | 112,814,547 | - | - | - | - | 112,814,547 |
| Total | $ 2,834,090,549 | $ 907,398,231 | $ 293,038,782 | $ 271,924,587 | $ 202,472,254 | $ 4,508,924,403 |

## 2. Cash and Investments (Continued)

| | December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Investment Maturities (in Years) | | | | | |
| | Less than 1 | 1-2 | 2-3 | 3-4 | 4-5 | Total |
| U.S. Treasuries | $ 2,271,005,195 | $ 1,351,634,751 | $ 176,346,556 | $ 33,686,100 | $ 55,692,624 | $ 3,888,365,226 |
| U.S. agencies | 307,225,721 | - | - | - | - | 307,225,721 |
| U.S. Gov't money market funds | 25,250,003 | - | - | - | - | 25,250,003 |
| Cash | 2,238,595 | - | - | - | - | 2,238,595 |
| Commercial paper | 49,961,729 | - | - | - | - | 49,961,729 |
| Total | $ 2,655,681,243 | $ 1,351,634,751 | $ 176,346,556 | $ 33,686,100 | $ 55,692,624 | $ 4,273,041,274 |

### *Interest Rate Risk*

As a means of limiting its exposure to fair value losses resulting from rising interest rates, the CEA's investment policy limits all securities purchased to a maximum maturity duration of 181 days, except for U.S. Treasuries. U.S. Treasuries are allowed to have maturities of up to 5 years as long as the CEA's combined portfolio does not exceed a maximum modified duration of 1.75 years. As of December 31, 2011, the CEA's combined portfolio had a maximum modified duration of 1.0 years.

### *Credit Risk*

The CEA investment policy limits investments in banker's acceptances and commercial paper to issuers with the highest rating category by all rating agencies that rate the issuer. The policy limits investments in corporate bonds to the top three ratings issued by nationally recognized rating services. As of December 31, 2011, 88% of the portfolio consisted of U.S. Treasuries and 12% of the portfolio consisted of U.S. Agencies, U.S. Government money market funds that invest exclusively in obligations of the U.S. Treasury, cash and commercial paper.

### *Concentration of Credit Risk*

There is no concentration of investments in any one non U. S. Governmental issuer that represents 5% or more of total investments.

### *Investment Income*

Total investment income is comprised of interest, realized gains and losses, and unrealized gains and losses due to changes in the fair value of investments held at year end. Investment income earned on unspent bond proceeds are offset against related interest expense and classified as financing expenses, net on the statements of revenues, expenses, and changes in net assets.

## 2. Cash and Investments (Continued)

***Investment Income (Continued)***

Investment income for the years ended December 31, 2011 and 2010 are as follows:

| | 2011 | 2010 |
|---|---|---|
| U.S. agency securities and government money market accounts | $ 634,357 | $ 594,901 |
| U.S. Treasuries | 30,942,605 | 39,716,242 |
| Other short-term investments | 129,948 | 97,723 |
| Interest income | 31,706,910 | 40,408,866 |
| Change in fair value of investments | 1,710,656 | (12,049,809) |
| Less investment expenses | (1,903,642) | (1,775,133) |
| Total investment income | $ 31,513,924 | $ 26,583,924 |

The following is a reconciliation of investment income to the statements of revenues, expenses, and changes in net assets:

| | 2011 | 2010 |
|---|---|---|
| Investment income included in financing expenses | $ 3,620,783 | $ 4,097,270 |
| Net investment income | 27,893,141 | 22,486,654 |
| Total investment income | $ 31,513,924 | $ 26,583,924 |

The change in fair value of investments for the years ended December 31, 2011 and 2010 are calculated as follows:

| | 2011 | 2010 |
|---|---|---|
| Fair value of investments at the end of year | $ 4,348,263,569 | $ 4,176,584,412 |
| Add: Proceeds of investments matured | 3,761,175,803 | 4,120,423,879 |
| Add: Amortization of premium and discount | 20,862,314 | 28,114,993 |
| Less: Cost of investments purchased | (3,952,006,618) | (4,389,600,177) |
| Less: Fair value of investments at the beginning of year | (4,176,584,412) | (3,947,572,916) |
| Change in fair value of investments | $ 1,710,656 | $ (12,049,809) |

***Fair Value of Financial Instruments***

The recorded value of other receivables and payables which are financial instruments approximates fair value due to the short-term nature of these assets and liabilities.

## 3. Long-Term Debt

The CEA issued its first long-term debt of $315 million in fixed rate revenue bonds on July 20, 2006 to enhance claims paying capacity. The following reflects activity in the long-term debt accounts during the years ended December 31, 2011 and 2010, respectively:

| | 2011 | 2010 |
|---|---|---|
| Balance at January 1, | $ 189,000,000 | $ 220,500,000 |
| Payments made in July, | (31,500,000) | (31,500,000) |
| Balance at December 31, | $ 157,500,000 | $ 189,000,000 |

The net proceeds from the revenue bonds were deposited into the Claims Paying Account and were used to purchase investments according to CEA's investment policy and procedures. The proceeds will only be used for future payments of earthquake policyholder claims and related loss adjustment expenses and may not be used to repay principal and interest of the debt. Revenue bond proceeds may be used for payment of claims after the CEA exhausts its capital available for claims and any capacity made available by reinsurance contracts. Repayment of debt does not affect the level of the Claims Paying Account.

The bonds are payable from future pledged policyholder premiums. The bonds bear interest at 6.169% and are federally taxable. Interest is payable semi-annually, beginning January 1, 2007. The bonds are due July 1, 2016, but are subject to annual mandatory sinking-fund payments as indicated below. The bonds are subject to optional redemptions at any time prior to maturity, in whole or in part, at the option of the CEA. The CEA is subject to certain bond covenants, the most restrictive of which requires a debt service coverage ratio, as defined, of 3:1.

Future scheduled debt service payments, including mandatory sinking-fund payments, for the CEA's long-term debt are as follows as of December 31, 2011:

| | Principal | Interest | Total |
|---|---|---|---|
| 2012 | $ 31,500,000 | $ 8,744,558 | $ 40,244,558 |
| 2013 | 31,500,000 | 6,801,323 | 38,301,323 |
| 2014 | 31,500,000 | 4,858,088 | 36,358,088 |
| 2015 | 31,500,000 | 2,914,853 | 34,414,853 |
| 2016 | 31,500,000 | 971,617 | 32,471,617 |
| Total requirements | $ 157,500,000 | $ 24,290,439 | $ 181,790,439 |

Interest paid during the year was $11,010,368 and $12,958,831 for 2011 and 2010, respectively.

## 3. Long-Term Debt (Continued)

***Fair Value***

The estimated fair value of the CEA's long-term debt, based on quoted market prices for the same or similar issues at December 31, 2011, is as follows:

| | |
|---|---|
| Carrying amount | $ 157,500,000 |
| Fair value | 177,593,850 |

## 4. Reinsurance

The CEA cedes risk to reinsurers under catastrophe excess-of-loss reinsurance contracts for purposes of limiting its maximum exposure. All contracts provide coverage for losses as well as allocated loss adjustment expenses. Although the ceding of risk does not discharge the CEA from its primary responsibility to its policyholders, the insurance company that assumes the coverage assumes responsibility to reimburse the CEA for the related liability. Management believes that its reinsurers are and will continue to be able to satisfy their obligations under the reinsurance agreements. To date, losses have been recovered only under the supplemental coverages reinsurance contracts. In the event that legislation is enacted by the State of California that has the effect of increasing a reinsurer's exposure to loss under the reinsurance contract, a reinsurer has the right to cancel the reinsurance contract.

During 2011, Embarcadero Reinsurance Ltd. (Embarcadero Re), an independent Bermuda insurance company, completed an offering of catastrophe bonds to unrelated investors of $150 million. In connection with the offering, Embarcadero Re entered into a reinsurance agreement (covering a three-year period) with the CEA, providing up to $150 million of reinsurance resulting from insured events. Under the terms of the reinsurance agreement, the CEA is obligated to pay annual reinsurance premiums to Embarcadero Re. The transaction is subject to a retention reset at the beginning of the second and third annual contract periods based on exposure adjustments and losses. The reinsurance agreement meets the requirements to be accounted for as reinsurance in accordance with the guidance for reinsurance contracts. The reinsurance limit will be reduced by any amounts paid to the CEA under the reinsurance agreement. At December 31, 2011, the CEA had $5,029,835 on deposit to ensure its performance under the terms of the agreement with Embarcadero Re.

The 2011 and 2010 aggregate excess reinsurance contracts allowed for an adjustment of premium, based on the average aggregate insurance in force and the exposure adjustment limit, as defined in the contracts. As of December 31, 2011, in accordance with these terms, the CEA did not have any premium adjustment expense against the contract. During 2011, the CEA continued to cede insurance to reinsurers under the catastrophe excess-of-loss reinsurance contracts providing maximum limits of $3.05 billion at varying attachment points.

Effective January 1, 2012, the CEA entered into reinsurance contracts that provide a maximum limit of $2.855 billion. The contracts have varying duration and expiration dates extending into future reporting periods.

## 5. Statutory Compliance

The State of California Insurance Code limits the CEA's "operating expenses" to 3% of its "premium income." In calculating this limitation, the CEA has determined that its premium income is its reported premiums written and that its operating expenses do not include certain start-up expenses and certain credits and payments, including payments to reinsurers, payments to investment managers and advisors, payments to participating insurers, or payments of agent commissions. Operating expenses, as determined by the CEA, totaled $11.0 million and $9.4 million for the years ended December 31, 2011 and 2010, respectively, and did not exceed 3% of premiums written.

## 6. Commitments and Contingencies

The CEA is a defendant in various legal actions arising from the normal course of business. Management does not believe that the ultimate disposition of these actions will have a material adverse effect on CEA's financial position or results of operations.

The CEA leases office facilities and equipment under various non-cancelable operating lease agreements that expire through December 2016. Rental expense associated with the lease agreements was $638,812 and $486,983 for the years ended December 31, 2011 and 2010, respectively. Future minimum rental payments under these agreements are as follows:

| | Amount |
|---|---|
| 2012 | $ 706,897 |
| 2013 | 722,439 |
| 2014 | 717,144 |
| 2015 | 727,069 |
| 2016 | 184,490 |
| Total | $ 3,058,039 |

## 7. Mitigation Fund

California Insurance Code (Code) Section 10089.37 created the Earthquake Loss Mitigation Fund (Mitigation Fund) as a "sub-account of the CEA". According to statute, the Mitigation Fund must be used solely for the establishment and operation of an earthquake loss mitigation program. The Code requires the CEA to annually transfer an amount equal to the lesser of 5% of investment income or $5 million to the Mitigation Fund if deemed actuarially sound by a consulting actuary. The transfer and setting aside of those monies into the Mitigation Fund sub-account have been formally approved by the CEA Governing Board. It is the opinion of the general counsel of the CEA and of the CEA's outside counsel that the monies that reside in the Mitigation Fund sub-account within the CEA are by statute not available to pay policyholder or other claims against the CEA.

As of December 31, 2011 and 2010, the balance sheets include expendable restricted net assets related to the Mitigation Fund totaling $25,537,617 and $24,302,326, respectively. The expendable restricted net assets of the Mitigation Fund as of December 31, 2011 include the potential annual transfer amount of $1,584,672, which is subject to actuarial review and formal approval of the CEA's Governing Board as discussed in the previous paragraph.

## 8. Retirement Plan, Deferred Compensation and Post-Employment Benefits

***Defined Benefit Plans***

The State of California sponsors a defined benefit pension plan covering all CEA civil-service employees. The benefits are based on the highest 12 consecutive months' compensation during their employment. The state's funding policy is to make the minimum annual contributions required by applicable regulations and charges the CEA for its allocable share of such contributions based on a percentage of payroll. The CEA has no legal obligation for benefits under this plan.

***Defined Contribution Plans***

The CEA sponsors a defined contribution savings plan for contract employees. Employees contribute 5% of compensation. The CEA contributes 12.71% of the employee's compensation. The contributions are funded semi-annually and allocated to the CEA based on employee contributions. The CEA has no legal obligation for benefits under this plan.

***Post-Employment Benefits***

The CEA has no obligations to former employees for benefits after their employment other than compensation related to earned vacation and severance. The liability for earned but untaken leave, such as vacation, personal leave days, or holiday credit, has been accrued to contract employees.

## 9. California Residential Mitigation Program

On August 16, 2011, the CEA entered into a Joint Powers Agreement with the California Emergency Management Agency (Cal EMA) to create the California Residential Mitigation Program (CRMP) for the purpose of supplying grants, loans, and loan guarantees (and related assistance and incentives) to owners of dwellings in California. The CRMP Governing Board is comprised of two employees of each the CEA and Cal EMA. Previously, on December 10, 2010, the CEA's Governing Board approved a $500,000 transfer from the CEA Mitigation Fund to the CRMP when certain conditions were met, mostly relating to the formation of the CRMP. In April 2012, those conditions were met and the CEA transferred the funds to the CRMP.

## 10. Subsequent Events

Management has evaluated subsequent events through August 20, 2012, which is the date the financial statements were made available to be issued. No events, other than those disclosed below and elsewhere in these financial statements, have occurred subsequent to December 31, 2011 requiring recording or disclosure in these financial statements.

On February 7, 2012, Embarcadero Re completed a second bond offering and entered into another reinsurance agreement with the CEA. The transaction provides the CEA an additional $150 million in reinsurance coverage.

On August 2, 2012, Embarcadero Re completed a third bond offering and entered into another reinsurance agreement with the CEA. The transaction provides the CEA an additional $300 million in reinsurance coverage.

# SUPPLEMENTARY INFORMATION

## CALIFORNIA EARTHQUAKE AUTHORITY

Schedule of Participating Insurer Capital Contributions
From Inception through December 31, 2011

| | | 2011 |
|---|---|---|
| State Farm General Insurance Company | $ | 254,658,275 |
| Allstate Insurance Company | | 145,612,517 |
| The Fire Insurance Exchange (Farmers) | | 143,280,000 |
| United Services Automobile Association[1] | | 58,992,512 |
| California State Automobile Association Inter-Insurance Bureau[2] | | 39,013,494 |
| Safeco Insurance Company of America[3] | | 46,500,000 |
| Nationwide Insurance Company[8] | | 20,772,000 |
| California FAIR Plan Association | | 15,029,487 |
| Interinsurance Exchange of the Automobile Club | | 14,443,651 |
| CNA/Continental[4] | | 13,924,611 |
| Prudential[4] | | 11,531,455 |
| Liberty Mutual Fire Insurance Company[5] | | 6,699,434 |
| Foremost Property and Casualty Insurance Company | | 4,614,304 |
| Mercury Casualty Company | | 1,406,238 |
| Armed Forces Insurance Exchange | | 783,685 |
| GuideOne (formerly Preferred Risk)[4] | | 123,133 |
| Merastar[6] | | - |
| Homesite Insurance Company of California | | - |
| Pacific National Insurance[4] | | - |
| Glen Falls Insurance Company[4] | | - |
| Commerce West Insurance Company | | - |
| Workmen's Auto Insurance[7] | | - |
| Total | $ | 777,384,796 |

[1]Includes Garrison Insurance Company

[2]Includes ACA Insurance Company

[3]Joined the CEA as of December 1, 2008

[4]Not currently writing residential property insurance in California

[5]Includes Golden Eagle Insurance Company

[6]Withdrew from the CEA as of May 1, 2009

[7]Withdrew from the CEA as of December 31, 2007

[8]Joined the CEA as of November 1, 2011

## CALIFORNIA EARTHQUAKE AUTHORITY

Schedules of Participating Insurer Premiums Written
For the Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| State Farm General Insurance Company | $ 219,132,203 | $ 212,325,217 |
| Allstate Insurance Company | 92,430,246 | 96,452,143 |
| The Fire Insurance Exchange (Farmers) | 75,330,427 | 78,443,512 |
| United Services Automobile Association[1] | 81,720,225 | 79,572,597 |
| California State Automobile Association Inter-Insurance Bureau[2] | 27,304,761 | 25,464,527 |
| Safeco Insurance Company of America[3] | 32,306,958 | 31,060,641 |
| California FAIR Plan Association | 4,715,894 | 4,546,230 |
| Interinsurance Exchange of the Automobile Club | 39,961,992 | 38,604,396 |
| CNA/Continental[4] | - | - |
| Prudential[4] | - | - |
| Liberty Mutual Fire Insurance Company[5] | 15,098,844 | 14,328,376 |
| Foremost Property and Casualty Insurance Company | 2,520,191 | 2,343,520 |
| Mercury Casualty Company | 15,506,120 | 14,158,005 |
| Armed Forces Insurance Exchange | 731,553 | 757,218 |
| GuideOne (formerly Preferred Risk)[4] | - | - |
| Merastar[6] | - | - |
| Homesite Insurance Company of California | 521,465 | 339,398 |
| Pacific National Insurance[4] | - | |
| Encompass Insurance Company | 4,153,175 | 4,720,884 |
| Glen Falls Insurance Company[4] | - | - |
| Commerce West Insurance Company | 26,022 | 11,025 |
| Workmen's Auto Insurance[7] | - | - |
| Nationwide Insurance Company[8] | 1,370,877 | - |
| Total | $ 612,830,953 | $ 603,127,689 |

[1]Includes Garrison Insurance Company

[2]Includes ACA Insurance Company

[3]Joined the CEA as of December 1, 2008

[4]Not currently writing residential property insurance in California

[5]Includes Golden Eagle Insurance Company

[6]Withdrew from the CEA as of May 1, 2009

[7]Withdrew from the CEA as of December 31, 2007

[8]Joined the CEA as of November 1, 2011

## CALIFORNIA EARTHQUAKE AUTHORITY

Schedules of Participating Insurer Unearned Premiums
As of December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| State Farm General Insurance Company | $ 108,836,524 | $ 105,588,276 |
| Allstate Insurance Company | 46,584,860 | 46,613,133 |
| The Fire Insurance Exchange (Farmers) | 37,155,208 | 39,311,113 |
| United Services Automobile Association[1] | 40,815,491 | 39,926,665 |
| California State Automobile Association Inter-Insurance Bureau[2] | 13,955,939 | 12,798,895 |
| Safeco Insurance Company of America[3] | 19,650,543 | 19,376,804 |
| California FAIR Plan Association | 2,416,204 | 2,348,100 |
| Interinsurance Exchange of the Automobile Club | 19,563,131 | 18,934,223 |
| CNA/Continental[4] | - | - |
| Prudential[4] | - | - |
| Liberty Mutual Fire Insurance Company[5] | 8,111,551 | 7,300,964 |
| Foremost Property and Casualty Insurance Company | 1,336,556 | 1,176,529 |
| Mercury Casualty Company | 7,581,421 | 6,887,490 |
| Armed Forces Insurance Exchange | 388,394 | 390,380 |
| GuideOne (formerly Preferred Risk)[4] | - | - |
| Merastar[6] | - | - |
| Homesite Insurance Company of California | 233,683 | 207,392 |
| Pacific National Insurance[4] | - | - |
| Encompass Insurance Company | 1,977,670 | 1,997,526 |
| Glen Falls Insurance Company[4] | - | - |
| Commerce West Insurance Company | 7,824 | 4,731 |
| Workmen's Auto Insurance[7] | - | - |
| Nationwide Insurance Company[8] | 1,284,332 | - |
| Total | $ 309,899,331 | $ 302,862,221 |

[1]Includes Garrison Insurance Company

[2]Includes ACA Insurance Company

[3]Joined the CEA as of December 1, 2008

[4]Not currently writing residential property insurance in California

[5]Includes Golden Eagle Insurance Company

[6]Withdrew from the CEA as of May 1, 2009

[7]Withdrew from the CEA as of December 31, 2007

[8]Joined the CEA as of November 1, 2011

**CALIFORNIA EARTHQUAKE AUTHORITY**

Schedules of Participating Insurer Commissions
For the Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| State Farm General Insurance Company | $ 21,603,880 | $ 21,302,966 |
| Allstate Insurance Company | 9,252,759 | 9,887,460 |
| The Fire Insurance Exchange (Farmers) | 7,754,381 | 7,760,842 |
| United Services Automobile Association[1] | 8,088,164 | 7,821,373 |
| California State Automobile Association Inter-Insurance Bureau[2] | 3,936,319 | 2,369,216 |
| Safeco Insurance Company of America[3] | 3,205,629 | 3,063,071 |
| California FAIR Plan Association | 465,038 | 456,091 |
| Interinsurance Exchange of the Automobile Club | 2,616,554 | 3,776,632 |
| CNA/Continental[4] | - | - |
| Prudential[4] | - | - |
| Liberty Mutual Fire Insurance Company[5] | 1,430,181 | 1,415,848 |
| Foremost Property and Casualty Insurance Company | 237,014 | 211,440 |
| Mercury Casualty Company | 1,482,192 | 1,338,999 |
| Armed Forces Insurance Exchange | 73,417 | 73,164 |
| GuideOne (formerly Preferred Risk)[4] | - | - |
| Merastar[6] | - | - |
| Homesite Insurance Company of California | 49,570 | 33,766 |
| Pacific National Insurance[4] | - | - |
| Encompass Insurance Company | 417,460 | 458,143 |
| Glen Falls Insurance Company[4] | - | - |
| Commerce West Insurance Company | 2,291 | 1,210 |
| Workmen's Auto Insurance[7] | - | - |
| Nationwide Insurance Company[8] | 8,728 | - |
| Total | $ 60,623,577 | $ 59,970,221 |

[1]Includes Garrison Insurance Company

[2]Includes ACA Insurance Company

[3]Joined the CEA as of December 1, 2008

[4]Not currently writing residential property insurance in California

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[6]Withdrew from the CEA as of May 1, 2009

[7]Withdrew from the CEA as of December 31, 2007

[8]Joined the CEA as of November 1, 2011

**CALIFORNIA EARTHQUAKE AUTHORITY**

Schedules of Participating Insurer Operating Costs
(Net of Deferred Acquisition Costs)
For the Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| State Farm General Insurance Company | $ 7,407,774 | $ 7,304,976 |
| Allstate Insurance Company | 3,172,508 | 3,389,823 |
| The Fire Insurance Exchange (Farmers) | 2,658,559 | 2,660,705 |
| United Services Automobile Association[1] | 2,773,506 | 2,681,722 |
| California State Automobile Association Inter-Insurance Bureau[2] | 896,465 | 812,630 |
| Safeco Insurance Company of America[3] | 1,090,284 | 1,050,973 |
| California FAIR Plan Association | 159,132 | 156,372 |
| Interinsurance Exchange of the Automobile Club | 1,351,818 | 1,296,553 |
| CNA/Continental[4] | - | - |
| Prudential[4] | - | - |
| Liberty Mutual Fire Insurance Company[5] | 487,858 | 486,460 |
| Foremost Property and Casualty Insurance Company | 80,862 | 72,328 |
| Mercury Casualty Company | 508,943 | 459,853 |
| Armed Forces Insurance Exchange | 25,117 | 25,091 |
| GuideOne (formerly Preferred Risk)[4] | - | - |
| Merastar[6] | - | - |
| Homesite Insurance Company of California | 17,595 | 12,127 |
| Pacific National Insurance[4] | - | - |
| Encompass Insurance Company | 142,963 | 157,136 |
| Glen Falls Insurance Company[4] | - | - |
| Commerce West Insurance Company | 788 | 416 |
| Workmen's Auto Insurance[7] | - | - |
| Nationwide Insurance Company[8] | 2,434 | - |
| Total | $ 20,776,606 | $ 20,567,165 |

[1]Includes Garrison Insurance Company

[2]Includes ACA Insurance Company

[3]Joined the CEA as of December 1, 2008

[4]Not currently writing residential property insurance in California

[5]Includes Golden Eagle Insurance Company

[6]Withdrew from the CEA as of May 1, 2009

[7]Withdrew from the CEA as of December 31, 2007

[8]Joined the CEA as of November 1, 2011