



The opening net assets (unaudited) as of January 1, 2002 have been restated for a correction of an error related to an overstatement of unearned ceded premium as discussed in Note 1 of the California Earthquake Authority's 2002 Audited Financial Statements

CALIFORNIA EARTHQUAKE AUTHORITY

Financial Statements

December 31, 2001 and 2000

(With Independent Auditors' Report Thereon)



Three Embarcadero Center
San Francisco, CA 94111

Independent Auditors' Report

The Board of Directors
California Earthquake Authority:

We have audited the accompanying balance sheets of the California Earthquake Authority (the Authority) as of December 31, 2001 and 2000, and the related statements of income, equity and comprehensive income (loss), and cash flows for the years then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 above present fairly, in all material respects, the financial position of the California Earthquake Authority as of December 31, 2001 and 2000, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included in schedules 1 through 3 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

May 20, 2002



KPMG, LLP, KPMG LLP, a limited liability partnership, is
a member of KPMG International, a Swiss association.

CALIFORNIA EARTHQUAKE AUTHORITY

Balance Sheets

December 31, 2001 and 2000

Assets	2001	2000
	<u> </u>	<u> </u>
Investments and cash:		
Cash and cash equivalents (note 8)	\$ 736,284,141	735,371,488
Available for sale investment securities, at fair value (amortized cost of \$516,634,294 and \$211,207,723 as of December 31, 2001 and 2000, respectively)	<u>516,744,294</u>	<u>211,200,358</u>
Total investments and cash	1,253,028,435	946,571,846
Premiums receivable, net of allowance for doubtful accounts of \$1,571,572 and \$2,362,854 in 2001 and 2000, respectively	26,129,791	35,463,931
Assessments receivable	3,100,200	9,993,911
Interest receivable (note 8)	4,735,071	8,156,426
Unearned ceded premiums	86,571,950	116,140,685
Prepaid reinsurance premiums	8,904,216	62,740,588
Prepaid line of credit fees	2,151,500	2,151,500
Reinsurance premiums receivable	—	28,896,403
Equipment, net	359,369	284,443
Deferred policy acquisition costs	27,778,884	27,741,921
Other assets	<u>380,953</u>	<u>90,828</u>
Total assets	<u>\$ 1,413,140,369</u>	<u>1,238,232,482</u>
Liabilities and Equity		
Unearned premiums, net	\$ 217,022,516	216,733,753
Unearned supplemental commission income	2,124,751	—
Claim and claim expense reserves	206,193	287,203
Reinsurance premiums payable	4,606,809	3,461,914
Accounts payable and accrued expenses (note 8)	<u>2,362,646</u>	<u>1,385,342</u>
Total liabilities	<u>226,322,915</u>	<u>221,868,212</u>
Commitments and contingencies (notes 1, 4, 5, and 8)		
Equity:		
Contributed capital	700,028,490	700,028,490
Additional paid-in capital	40,899,390	31,220,093
Mitigation Fund (note 8)	639,333	844,747
Retained earnings	445,140,241	284,278,305
Accumulated other comprehensive income (loss)	<u>110,000</u>	<u>(7,365)</u>
Total equity	<u>1,186,817,454</u>	<u>1,016,364,270</u>
Total liabilities and equity	<u>\$ 1,413,140,369</u>	<u>1,238,232,482</u>

See accompanying notes to financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY

Statements of Income

Years ended December 31, 2001 and 2000

	<u>2001</u>	<u>2000</u>
Underwriting income:		
Premiums written	\$ 426,830,232	432,770,846
Less premiums ceded – reinsurance	<u>(192,606,198)</u>	<u>(239,758,292)</u>
Net premiums written	<u>234,224,034</u>	<u>193,012,554</u>
Change in unearned premiums	(288,763)	3,030,361
Change in unearned premiums ceded – reinsurance	<u>(29,568,735)</u>	<u>(31,926,625)</u>
Net unearned premiums	<u>(29,857,498)</u>	<u>(28,896,264)</u>
Net premiums earned	<u>204,366,536</u>	<u>164,116,290</u>
Expenses:		
Claims and claim expenses	134,495	(297,370)
Participating insurer commissions	42,710,560	43,649,481
Participating insurer operating costs	11,929,659	12,214,986
Reinsurance broker commissions	10,849,998	10,850,000
Pro forma premium taxes	9,679,297	9,617,655
Line of credit fees	4,733,090	4,951,320
Mitigation Fund expenses	2,030,237	3,499,500
Other underwriting expenses	<u>7,401,944</u>	<u>7,068,243</u>
Total expenses	<u>89,469,280</u>	<u>91,553,815</u>
Underwriting profit	114,897,256	72,562,475
Net investment income	43,190,028	51,409,865
Supplemental commission income, net	2,162,684	3,382,762
Other income	<u>406,554</u>	<u>463,666</u>
Net income	<u>\$ 160,656,522</u>	<u>127,818,768</u>

See accompanying notes to financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY
 Statements of Equity and Comprehensive Income (Loss)
 Years ended December 31, 2001 and 2000

	<u>Contributed capital</u>	<u>Additional paid-in capital</u>	<u>Mitigation Fund (note 8)</u>	<u>Retained earnings</u>	<u>Accumulated other comprehensive income (loss)</u>	<u>Total equity</u>
Balances as of December 31, 1999	\$ 700,028,490	21,602,438	2,624,367	154,679,917	9,355	<u>878,944,567</u>
Comprehensive income:						
Net income	—	—	—	127,818,768	—	127,818,768
Other comprehensive loss:						
Unrealized holding losses arising during the year	—	—	—	—	(15,821)	—
Less reclassification adjustments for gains included in net income	—	—	—	—	(899)	—
Other comprehensive loss	—	—	—	—	<u>(16,720)</u>	<u>(16,720)</u>
Comprehensive income						<u>127,802,048</u>
Contribution to the Mitigation Fund	—	—	1,568,614	(1,568,614)	—	—
Allocations of Mitigation Fund costs	—	—	(3,348,234)	3,348,234	—	—
State of California premium tax contribution	—	9,617,655	—	—	—	<u>9,617,655</u>
Balances as of December 31, 2000	<u>700,028,490</u>	<u>31,220,093</u>	<u>844,747</u>	<u>284,278,305</u>	<u>(7,365)</u>	<u>1,016,364,270</u>
Comprehensive income:						
Net income	—	—	—	160,656,522	—	160,656,522
Other comprehensive income:						
Unrealized holding gains arising during the year	—	—	—	—	110,000	—
Less reclassification adjustments for losses included in net income	—	—	—	—	7,365	—
Other comprehensive income	—	—	—	—	<u>117,365</u>	<u>117,365</u>
Comprehensive income						<u>160,773,887</u>
Contribution to the Mitigation Fund	—	—	1,771,808	(1,771,808)	—	—
Allocations of Mitigation Fund costs	—	—	(1,977,222)	1,977,222	—	—
State of California premium tax contribution	—	9,679,297	—	—	—	<u>9,679,297</u>
Balances as of December 31, 2001	<u>\$ 700,028,490</u>	<u>40,899,390</u>	<u>639,333</u>	<u>445,140,241</u>	<u>110,000</u>	<u>1,186,817,454</u>

See accompanying notes to financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY

Statements of Cash Flows

Years ended December 31, 2001 and 2000

	<u>2001</u>	<u>2000</u>
Cash flows from operating activities:		
Net income	\$ 160,656,522	127,818,768
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and accretion	(3,532,319)	(3,285,498)
Pro forma premium tax expense	9,679,297	9,617,655
Changes in operating assets and liabilities:		
Premiums receivable, net	9,334,140	(1,356,059)
Interest receivable	3,421,355	(5,167,880)
Unearned ceded premiums	29,568,735	31,926,625
Prepaid reinsurance premiums	53,836,372	67,870,284
Reinsurance premiums receivable	28,896,403	51,754,868
Deferred policy acquisition costs	(36,963)	387,886
Other assets	(290,125)	(53,581)
Unearned premiums, net	288,763	(3,030,361)
Unearned supplemental commission income	2,124,751	—
Reinsurance premiums payable	1,144,895	578,919
Claims and claim expense reserves	(81,010)	(455,569)
Accounts payable and accrued expenses	977,304	(232,442)
Net cash provided by operating activities	<u>295,988,120</u>	<u>276,373,615</u>
Cash flows from investing activities:		
Proceeds from maturities of available-for-sale investment securities	3,613,528,622	1,155,185,647
Proceeds from sales of available-for-sale investment securities	422,469,799	179,427,344
Purchases of available-for-sale investment securities	(4,337,715,922)	(1,429,159,658)
Purchases of equipment	(251,677)	(105,119)
Net cash used in investing activities	<u>(301,969,178)</u>	<u>(94,651,786)</u>
Cash flows provided by financing activities – assessments received from participating insurers	<u>6,893,711</u>	<u>7,007,261</u>
Net increase in cash and cash equivalents	912,653	188,729,090
Cash and cash equivalents, beginning of year	<u>735,371,488</u>	<u>546,642,398</u>
Cash and cash equivalents, end of year	<u>\$ 736,284,141</u>	<u>735,371,488</u>

See accompanying notes to financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

(1) Organization and Summary of Significant Accounting Policies

(a) *Organization*

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. Effective July 1, 1999, the CEA also provides supplemental insurance coverage for earthquake damage.

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 3-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 consumer and insurance industry representatives.

CEA policies are sold to policyholders by participating insurance carriers of the CEA. Insurance companies admitted to write residential property insurance in California and who elected to become participating members of the CEA signed Insurer Participation Agreements with 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 underwriting, policy issuance, premium collection, and claims adjustment.

Under the agreements, the CEA reimburses participating insurers for nonclaims-related operating costs incurred by these companies in servicing CEA policies. The operating cost reimbursement is equal to 2.80% of premiums written for CEA policies. Additionally, participating insurers receive reimbursement for expenses associated with servicing CEA claims equal to 9% of the paid claim, as well as a producer commission equal to 10% of premiums written for CEA policies. As of December 31, 2001, there were 19 participating insurance carriers of the CEA, who have commenced writing CEA policies.

(b) *Basis of Presentation*

The accompanying financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. 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.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

(c) Revenue Recognition

The CEA's premium rates are required to be actuarially sound and are based on the modeling of potential loss scenarios due to a major earthquake event. Premiums are recognized as earned on a pro rata basis over the contract period. Unearned premiums represent amounts collected which relate to coverage in future periods.

Premiums paid or accrued by the CEA under reinsurance agreements, net of estimated return premiums, are accounted for as a reduction in the related premium revenue earned and are amortized over the remaining contract period in proportion to the amount of insurance protection provided.

(d) Cash and Cash Equivalents

For purposes of the statement of cash flows, the CEA considers investments in certificates of deposits, U.S. government money market accounts, banker's acceptances, repurchase agreements, and commercial paper with original maturities of three months or less, to be cash equivalents. In order to reduce counterparty exposure, the CEA maintains collateral of generally 105% on repurchase agreements.

(e) Investments

All of the CEA's investments are classified as available-for-sale securities and are carried at fair value with the corresponding unrealized gains and losses excluded from earnings and reported in other comprehensive income. Declines in market value considered to be other than temporary are charged to realized losses. Net realized investment gains and losses on sales of investments are reported in the statements of income based on the specific identification method.

(f) Deferred Policy Acquisition Costs

Acquisition costs, consisting of participating insurer commissions and operating costs, are deferred and amortized ratably 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.

(g) 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. Estimations are revised as more information becomes available. Since the CEA's inception, there has not been a major earthquake. If a major earthquake were to occur, there would be a significant increase in the reserve for claims and claim adjustment expenses.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

(h) Reinsurance

Reinsurance receivables (including amounts related to losses incurred but not reported) and prepaid reinsurance premiums are reported as assets. Estimated reinsurance receivables are recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts. Reinsurance agreements which do not transfer risk to the reinsurer are accounted for as financing arrangements.

(i) 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. Participating insurers retained the risk of earthquake losses on individual earthquake policies until the policies were renewed into the CEA. Participating insurers were given the option to pay capital contribution assessments in 12 or 60 monthly installments, depending on their residential property insurance market share percentage. Installments are payable on the first day of each successive calendar month after the insurer begins to transfer risk of earthquake losses on individual earthquake policies to the CEA. In the event of a major earthquake and if the CEA's available funds are inadequate to meet claims liabilities, the entire amount of capital contributions will become due and payable within 30 days after notification by the CEA.

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.

A minimum of \$700,000,000 in capital commitments was required in order for the CEA to become operational. As of December 31, 2001 and 2000, participating insurer capital contributions totaled \$700,028,490, of which \$3,100,200 and \$9,993,911 were unfunded and are classified as assessments receivable in the accompanying financial statements as of December 31, 2001 and 2000, respectively.

(j) Equipment

Equipment is stated at cost less accumulated depreciation of \$664,303 and \$612,756 as of December 31, 2001 and 2000, respectively. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. Amortization of leasehold improvements is calculated using the straight-line method over the lives of the related assets, not to exceed the lease term. Maintenance and repairs are charged against income as incurred.

(k) 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.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

(l) *State of California Premium Tax Contribution*

For California tax purposes, California Insurance Code Section 10089.44 provides that “premiums collected by the CEA 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 CEA.” As a result, an amount equivalent to the 2.35% California premium tax is included in the premium rate base for CEA policies collected from policyholders. As premiums are earned, the associated premium tax equivalent is recorded as pro forma premium tax expense and as a capital contribution from the state of California.

(m) *Supplemental Commission Income*

The CEA earns a 20% commission income, net of premium tax, from participating insurers on supplemental insurance policies written. Unearned supplemental commission income related to the unearned supplemental premiums written was \$2,124,751 and \$0 as of December 31, 2001 and 2000, respectively.

(n) *Recent Adopted Accounting Standards*

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS No. 133, as amended by SFAS No. 137 and No. 138, requires the CEA to recognize all derivatives on the balance sheet at fair value. The CEA adopted SFAS No. 133 on January 1, 2001. SFAS No. 133 has had no impact on CEA’s financial statements.

In September 2000, the FASB issued SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities – an amendment of FASB Statement No. 125*. SFAS No. 140 revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosure, but it carries over most of the provisions of SFAS No. 125 without reconsideration. SFAS No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. Adoption of SFAS No. 140 did not have any impact on CEA’s financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

(2) Investments and Fair Value of Financial Instruments

Investment income for the years ended December 31, 2001 and 2000 was as follows:

	2001	2000
Certificates of deposit	\$ 7,355,411	12,326,989
U.S. agency securities and government money market accounts	8,177,867	947,892
Repurchase agreements	10,823,912	14,057,795
Corporate bonds	5,908,838	5,685,933
Other short-term investments	12,088,843	19,258,542
Interest income	44,354,871	52,277,151
Less investment expenses	(1,164,843)	(867,286)
Net investment income	\$ 43,190,028	51,409,865

The amortized cost and estimated fair values of available for sale investment securities as of December 31 are as follows:

	2001			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. agency securities	\$ 280,901,301	48,813	(7,263)	280,942,851
Corporate bonds	161,603,218	109,537	(23,367)	161,689,388
Certificates of deposit	74,129,775	—	(17,720)	74,112,055
Total available-for-sale investment securities	\$ 516,634,294	158,350	(48,350)	516,744,294

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

		2000			
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. agency securities	\$	73,397,439	—	—	73,397,439
Corporate bonds		109,663,439	—	(7,365)	109,656,074
Certificates of deposit		25,204,082	—	—	25,204,082
Bankers' acceptances		2,942,763	—	—	2,942,763
Total available-for-sale investment securities		\$ <u>211,207,723</u>	<u>—</u>	<u>(7,365)</u>	<u>211,200,358</u>

All of the fixed maturity securities are due, by contractual maturity, within one year or less. Fair values for available-for-sale investment securities are based on quoted market prices.

Proceeds from maturities of available-for-sale securities during the years ended December 31, 2001 and 2000 were \$3,613,528,622 and \$1,155,185,647, respectively. Proceeds from sales of available for sale securities during 2001 and 2000 were \$422,469,799 and \$179,427,344, respectively. Gross gains of \$27,939 and \$899 and gross losses of \$3,532 and \$0, respectively, were realized on those sales and are included in net investment income in the accompanying statements of income in 2001 and 2000. The fair value of assessments receivable from participating insurers as of December 31, 2001 and 2000, of \$3,099,878 and \$9,936,753, respectively, is determined as the discounted value of expected future cash flows. The discount rate is estimated using rates currently offered on notes with similar characteristics. 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) Line of Credit

The CEA has available up to \$716,810,000 of loans and/or letters of credit through a committed catastrophe contract entered into on July 1, 1999 with a consortium of insurance and reinsurance companies. Available borrowings under this contract will be provided if claims paid by the CEA following an earthquake exhaust the total of the CEA's available capital, the maximum amount of all participating insurer capital contributions and the first aggregate level of reinsurance available and under contract to the CEA.

Prepaid line of credit fees are \$2,151,500 as of December 31, 2001 and 2000. The total amount of expense associated with the committed catastrophe contract and credit agreement, including arrangement, commitment, and administrative fees, was \$4,733,090 and \$4,951,320 during the years ended December 31, 2001 and 2000, respectively. There were no amounts outstanding under these arrangements as of December 31, 2001 and 2000.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

(4) Reinsurance

The CEA cedes insurance to reinsurers under two catastrophe excess of loss reinsurance contracts and a supplemental policy reinsurance contract, for purposes of limiting its maximum exposure on any one loss. All contracts provide coverage for losses as well as allocated loss adjustment expenses. Although the ceding of insurance 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. No losses have been ceded under these contracts as of December 31, 2001.

The first aggregate excess reinsurance contract expired on December 31, 2001. The contract provides coverage of a maximum of \$1.434 billion in excess of the CEA's claims paying ability, representing \$2 billion multiplied by the total residential property insurance market share of CEA's participating insurers of 71.681%. Additionally, effective January 1, 1999, a reinstatement provision allowed an additional limit of liability equal to the amount of reinsurance exhausted, subject to an aggregate maximum limit of \$1.434 billion. The first aggregate excess reinsurance contract was extended for one year effective January 1, 2002 through December 31, 2002.

The second aggregate excess reinsurance contract is a five-year contract, which will expire on March 31, 2002. The contract provides maximum coverage of \$1.075 billion, equal to \$1.5 billion multiplied by the total residential property insurance market share of CEA's participating insurers of 71.681%. The CEA exercised its option to reduce the coverage under this agreement to a maximum of \$537.6 million in excess of the CEA's claims paying ability effective for the fifth year of the contract. As of December 31, 2001 and 2000, there was \$8,904,216 and \$35,616,497, respectively, which was paid on April 1, 2000, included in the balance sheet as prepaid reinsurance premiums related to this second aggregate excess reinsurance contract. Subsequent to March 31, 2002, the contract was extended from April 1, 2002 and set to expire on December 31, 2002.

The CEA also entered into a supplemental policy quota share reinsurance contract effective July 1, 1999, expiring on June 30, 2002. Under the terms of this contract, the CEA cedes 100% of its gross liability under supplemental insurance policies to the reinsurer, in return for ceding 100% of premiums written on this business. The reinsurer allows the CEA a 20% commission on all premiums ceded.

The first aggregate excess reinsurance contract requires the CEA to pay minimum premiums of \$359,063,100 payable in installments over the three-year life of the contract. The minimum payments remaining under this contract as of December 31, 2001 and 2000 are \$0 and \$117,347,700, respectively. There were no minimum payments remaining under the second aggregate excess reinsurance contract as of December 31, 2001 or 2000.

Effective January 1, 1999, the first aggregate excess reinsurance contract allows for an adjustment of premium, based on the average aggregate insurance in force (AAIIF) and the exposure adjustment limit (EAL), as defined in the contract. The EAL is \$203.6 billion in 1999 and \$178.8 billion for 2000 and 2001. If the AAIIF is less than 90% of the EAL, the CEA will receive a return premium equal to the percentage point difference between the AAIIF and 90% of the EAL, multiplied by the original ceded premium for that year and subject to a maximum return premium of 10% of the ceded premium. If the AAIIF is more than 110% of the EAL, the CEA will pay an additional premium equal to the percentage point difference

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

between the AAIIF and 110% of the EAL, multiplied by the original ceded premium for that year and subject to a maximum additional premium of 10% of the ceded premium. Additionally, the reinsurance contract was amended in 1999 to provide for a 'no claims bonus' for 1997, 1998 and 1999. Since the reinsurer sustained no loss under the contract as a result of loss occurrences commencing on or before December 31, 1999, the CEA was entitled to additional return premiums representing a 'no claims bonus' for 1997, 1998, and 1999, equal to 12.5% of the total reinsurance premium ceded for those years.

For the years ended December 31, 2001 and 2000, in accordance with these terms, the CEA was not entitled to any return premiums.

(5) Commitments and Contingencies

Operating Lease

As of December 31, 2001, the CEA occupied office space under an operating lease which extends to the year 2006. The future minimum lease payments under the operating lease as of December 31, 2001 are as follows:

Year ending December 31:	
2002	\$ 169,907
2003	175,004
2004	180,254
2005	185,662
2006	110,721
	<hr/>
	\$ 821,548

Rental expense of \$237,439 and \$234,212 for the years ended December 31, 2001 and 2000, respectively, have been charged to operations in the accompanying statements of income.

(6) Statutory Compliance

The State of California Insurance Code limits 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 gross premium income 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 payment of agent commissions. Operating expenses, as determined by the CEA, for the years ended December 31, 2001 and 2000, totaled \$7,401,944 and \$7,068,243, respectively, and did not exceed 3% of premium income.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

(7) Employee Benefit Plans

The CEA's civil service employees are eligible for benefits under the State of California's First-Tier and Second-Tier retirement plans. Both plans are managed by the California Public Employees' Retirement System. Under the First-Tier plan, both the participant and the state of California make contributions, whereas benefits under the Second-Tier plan are funded entirely by the state of California. The CEA is responsible for reimbursing the state of California for the costs associated with providing benefits to its civil service employees. The CEA incurred expenses associated with these plans of \$0 in each of the years ending December 31, 2001 and 2000.

Officers of the CEA are eligible for benefits under the CEA Retirement Plan, a defined contribution plan designed to comply with all applicable tax qualification requirements. Discretionary contributions to the plan are made semi-annually and participants are fully vested in their individual participant accounts. Contributions to the CEA Retirement Plan were \$91,196 and \$86,345 for the years ended December 31, 2001 and 2000, respectively.

Officers of the CEA are also eligible for benefits under the CEA Deferred Compensation Plan, an eligible deferred compensation plan as defined in section 457(b) of the Internal Revenue Code of 1986. The plan allows officers of the CEA to defer portions of their annual compensation. Officers' compensation deferred under the CEA Deferred Compensation Plan was \$23,500 and \$15,000 as of December 31, 2001 and 2000, respectively.

(8) Mitigation Fund

California Insurance Code Section 10089.37 creates the Earthquake Loss Mitigation Fund (Mitigation Fund) as a subaccount of the CEA. By statute, the Mitigation Fund must be used solely for the establishment and operation of the mitigation program. The mitigation program is a residential retrofit program available to certain homeowners who can receive detailed seismic risk assessments of their homes, referrals to contractors trained and experienced in seismic safety work, low-interest loans to help pay for safety improvements, and reductions in CEA insurance premiums for those who qualify. In compliance with statutory requirements, the CEA's actuary has opined that the setting aside of these monies into the Mitigation Fund does not impair the actuarial soundness of the CEA. The transfer and setting aside of those monies into the Mitigation Fund subaccount 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 are resident in the Mitigation Fund subaccount within the CEA are by statute not available to pay policyholder or other claims against the CEA. Accordingly, equity related to the Mitigation Fund has been segregated in the accompanying balance sheets and statements of equity.

CALIFORNIA EARTHQUAKE AUTHORITY

Notes to Financial Statements

December 31, 2001 and 2000

As of December 31, 2001 and 2000, the balance sheets of the CEA include the following amounts related to the Mitigation Fund:

	<u>2001</u>	<u>2000</u>
Cash and cash equivalents	\$ 1,149,610	1,383,961
Interest receivable	1,915	9,726
Accounts payable	<u>(512,192)</u>	<u>(548,940)</u>
	<u>\$ 639,333</u>	<u>844,747</u>

There is an additional contribution to the Mitigation Fund of \$1,899,974 available for approval by the CEA governing board with respect to the year ended December 31, 2001.

SUPPLEMENTARY INFORMATION

CALIFORNIA EARTHQUAKE AUTHORITY

Schedule of Participating Insurer Assessments

	December 31, 2001	
	Assessment	Assessment receivable
Allstate Insurance Company	\$ 145,612,517	—
Farmers Insurance Company	143,280,000	—
State Farm Insurance Company	249,188,275	—
United Services Automobile Association	58,992,512	—
Liberty Mutual Insurance Company	6,812,984	113,550
California Fair Plan	15,029,487	—
California State Automobile Association	39,013,493	—
GuideOne (formerly Preferred Risk)	123,133	6,157
Automobile Insurance Exchange of Southern California	14,443,651	—
Armed Forces	783,685	39,184
CNA/Continental	13,924,609	696,229
Prudential Insurance Company	11,531,456	1,921,908
Mercury Insurance Company	1,292,688	323,172
Total	<u>\$ 700,028,490</u>	<u>3,100,200</u>

	December 31, 2000	
	Assessment	Assessment receivable
Allstate Insurance Company	\$ 145,612,517	—
Farmers Insurance Company	143,280,000	—
State Farm Insurance Company	249,188,275	—
United Services Automobile Association	58,992,512	—
Liberty Mutual Insurance Company	6,812,984	1,476,146
California Fair Plan	15,029,487	—
California State Automobile Association	39,013,493	—
GuideOne (formerly Preferred Risk)	123,133	30,784
Automobile Insurance Exchange of Southern California	14,443,651	—
Armed Forces	783,685	195,921
CNA/Continental	13,924,609	3,481,151
Prudential Insurance Company	11,531,456	4,228,200
Mercury Insurance Company	1,292,688	581,709
Total	<u>\$ 700,028,490</u>	<u>9,993,911</u>

See accompanying independent auditors' report.

CALIFORNIA EARTHQUAKE AUTHORITY

Schedule of Participating Insurer Premiums Written and Unearned

	Year ended December 31, 2001	
	Premiums written	Unearned premiums
Allstate Insurance Company	\$ 82,449,188	47,436,466
Farmers Insurance Company	62,385,440	30,654,078
State Farm Insurance Company	163,872,020	80,621,899
United Services Automobile Association	54,890,631	27,090,015
Liberty Mutual Insurance Company	5,787,715	2,875,831
California Fair Plan	7,381,441	3,796,034
California State Automobile Association	12,348,902	5,806,999
GuideOne (formerly Preferred Risk)	31,518	15,700
Automobile Insurance Exchange of Southern California	22,835,563	11,050,387
Armed Forces	656,785	323,107
Encompass Glen Falls (formerly CNA/Continental)	4,901,521	2,846,704
Prudential Insurance Company	4,787,748	2,347,243
Mercury Insurance Company	3,523,728	1,702,906
Merastar (affiliated with Prudential Insurance Company)	20,210	12,851
Golden Eagle (affiliated with Liberty Mutual Insurance Company)	854,104	381,227
Homesite Insurance	67,182	47,258
Workmen's Auto Insurance	9,630	5,090
Pacific National Insurance	26,906	8,721
Total	\$ 426,830,232	217,022,516

	Year ended December 31, 2000	
	Premiums written	Unearned premiums
Allstate Insurance Company	\$ 92,286,130	56,963,714
Farmers Insurance Company	68,577,129	32,594,952
State Farm Insurance Company	157,781,662	72,909,027
United Services Automobile Association	53,635,757	24,826,625
Liberty Mutual Insurance Company	5,600,328	2,750,817
California Fair Plan	8,477,589	3,975,307
California State Automobile Association	10,949,066	5,134,442
GuideOne (formerly Preferred Risk)	25,130	10,803
Automobile Insurance Exchange of Southern California	21,846,954	10,305,572
Armed Forces	666,941	328,675
Encompass Glen Falls (formerly CNA/Continental)	4,940,102	2,845,502
Prudential Insurance Company	4,716,604	2,447,592
Mercury Insurance Company	2,474,193	1,219,384
Merastar (affiliated with Prudential Insurance Company)	9,700	5,209
Golden Eagle (affiliated with Liberty Mutual Insurance Company)	766,924	407,435
Homesite Insurance	1,696	1,345
Workmen's Auto Insurance	5	4
Pacific National Insurance	14,936	7,348
Total	\$ 432,770,846	216,733,753

See accompanying independent auditors' report.

CALIFORNIA EARTHQUAKE AUTHORITY

Schedule of Participating Insurer Commissions and Operating Costs

	Year ended December 31, 2001	
	Commissions	Operating costs
Allstate Insurance Company	\$ 9,207,184	2,575,816
Farmers Insurance Company	6,441,137	1,794,635
State Farm Insurance Company	15,641,568	4,364,370
United Services Automobile Association	5,268,038	1,474,708
Liberty Mutual Insurance Company	567,126	158,459
California Fair Plan	756,698	211,657
California State Automobile Association (CSAA)	1,168,854	326,789
GuideOne (formerly Preferred Risk)	2,665	747
Automobile Insurance Exchange of Southern California	2,211,744	618,627
Armed Forces	66,282	18,547
Encompass Glen Falls (formerly CNA/Continental)	490,413	137,218
Prudential Insurance Company	489,710	136,645
Mercury Insurance Company	304,586	85,032
Merastar (affiliated with Prudential Insurance Company)	1,265	351
Golden Eagle (affiliated with Liberty Mutual Insurance Company)	88,143	24,622
Homesite Insurance	2,136	594
Workmen's Auto Insurance	455	128
Pacific National Insurance	2,556	714
Total	\$ 42,710,560	11,929,659

	Year ended December 31, 2000	
	Commissions	Operating costs
Allstate Insurance Company	\$ 9,214,486	2,577,215
Farmers Insurance Company	7,137,981	2,013,740
State Farm Insurance Company	15,896,747	4,435,234
United Services Automobile Association	5,325,247	1,490,549
Liberty Mutual Insurance Company	564,250	157,514
California Fair Plan	942,137	263,195
California State Automobile Association	1,124,026	314,227
GuideOne (formerly Preferred Risk)	2,704	759
Automobile Insurance Exchange of Southern California	2,127,484	594,973
Armed Forces	69,132	19,314
Encompass Glen Falls (formerly CNA/Continental)	501,679	140,709
Prudential Insurance Company	481,510	134,356
Mercury Insurance Company	203,716	56,853
Merastar (affiliated with Prudential Insurance Company)	456	127
Golden Eagle (affiliated with Liberty Mutual Insurance Company)	57,127	16,002
Homesite Insurance	39	8
Workmen's Auto Insurance	1	—
Pacific National Insurance	759	211
Total	\$ 43,649,481	12,214,986

See accompanying independent auditors' report.