CALIFORNIA EARTHQUAKE AUTHORITY

Financial Statements

December 31, 1997

(With Independent Auditors' Report Thereon)

KPMG Peat Marwick LLP

400 Capitol Mall
Sacramento, CA 95814

INDEPENDENT AUDITORS' REPORT

The Board of Directors
California Earthquake Authority:

We have audited the accompanying balance sheet of the California Earthquake Authority (the Authority) as of December 31, 1997, and the related statements of operations, equity and cash flows for the period from December 1, 1996 (inception) to December 31, 1997. 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 audit.

We conducted our audit in accordance with generally accepted auditing standards. 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 audit provides 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, 1997, and the results of its operations and its cash flows for the period from December 1, 1996 (inception) to December 31, 1997, in conformity with generally accepted accounting principles.

Our audit was 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 Peat Marwick LLP

March 6, 1998

CALIFORNIA EARTHQUAKE AUTHORITY

Balance Sheet

December 31, 1997

Assets

Investments and cash:	
Cash and cash equivalents	$ 509,835,903
Available for sale investment securities, at fair value (amortized cost of $66,201,426)	66,192,138
Total investments and cash	576,028,041
Premiums receivable	29,509,143
Assessments receivable	68,074,134
Interest receivable	996,925
Unearned ceded premiums	146,705,086
Prepaid reinsurance premiums	132,144,570
Prepaid line of credit fees	3,112,887
Equipment, net	369,328
Deferred policy acquisition costs	32,462,515
Other assets	20,644
Total assets	$ 989,423,273

Liabilities and Equity

Unearned premiums	$ 238,323,626
Less estimated policy refunds on unearned premiums	(21,748,155)
Unearned premiums, net	216,575,471
Reinsurance premiums payable	15,536,857
Accounts payable and accrued expenses	988,583
Accrued liability for estimated policy refunds	38,182,490
Total liabilities	271,283,401
Commitments and contingencies (notes 1, 4 and 5)	
Equity:	
Contributed capital	700,028,490
Additional paid-in capital	3,468,687
Net unrealized losses on investments	(9,288)
Retained earnings	14,651,983
Total equity	718,139,872
Total liabilities and equity	$ 989,423,273

See accompanying notes to financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY

Statement of Operations

Period from December 1, 1996 (inception) to December 31, 1997

Underwriting income:	
Premiums written	$ 388,122,181
Less premiums ceded (reinsurance)	(237,317,225)
Net premiums written	150,804,956
Change in unearned premiums	(238,323,626)
Less unearned premiums ceded (reinsurance)	146,705,086
Net unearned premiums	(91,618,540)
Estimated policy refunds	(13,431,650)
Net premiums earned	45,754,766
Expenses:	
Participating insurer commissions	15,005,460
Participating insurer operating costs	5,398,416
Reinsurance broker commissions	10,850,000
Pro forma premium taxes	3,459,237
Line of credit fees	3,793,213
Estimated policy refund expenses	3,002,685
Other underwriting expenses	7,215,607
Total expenses	48,724,618
Underwriting loss	(2,969,852)
Net investment income	17,577,267
Other income	44,568
Net income	$ 14,651,983

See accompanying notes to financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY

Statement of Equity

Period from December 1, 1996 (inception) to December 31, 1997

		Contributed Capital	Additional Paid-In Capital	Net Unrealized Losses on Investments	Retained Earnings	Total Equity
Balances at December 1, 1996	$	—	—	—	—	—
Participating insurer capital contributions		700,028,490	—	—	—	700,028,490
State of California premium tax contribution		—	3,459,237	—	—	3,459,237
Donated equipment		—	9,450	—	—	9,450
Net unrealized losses on investments		—	—	(9,288)	—	(9,288)
Net income		—	—	—	14,651,983	14,651,983
Balances at December 31, 1997	$	700,028,490	3,468,687	(9,288)	14,651,983	718,139,872

See accompanying notes to financial statements.

CALIFORNIA EARTHQUAKE AUTHORITY

Statement of Cash Flows

Period from December 1, 1996 (inception) to December 31, 1997

Cash flows from operating activities:	
Net income	$ 14,651,983
Adjustment to reconcile net income to net cash used in operating activities:	
Depreciation and accretion	(2,793,000)
Increase in premiums receivable	(29,509,143)
Increase in interest receivable	(996,925)
Increase in unearned ceded premiums	(146,705,086)
Increase in prepaid reinsurance premiums	(132,144,570)
Increase in prepaid line of credit fees	(3,112,887)
Increase in unearned premiums, net	216,575,471
Increase in deferred policy acquisition costs	(32,462,515)
Increase in other assets	(20,644)
Increase in reinsurance premiums payable	15,536,857
Increase in accounts payable and accrued expenses	988,583
Increase in contingent liability for policy refunds	38,182,490
Pro forma premium tax expense	3,459,237
Net cash used in operating activities	(58,350,149)
Cash flows from investing activities:	
Proceeds from maturities of available for sale investment securities	784,714,624
Purchases of available for sale investment securities	(848,006,639)
Purchases of equipment	(476,289)
Net cash used in investing activities	(63,768,304)
Cash flows from financing activities:	
Assessments received from participating insurers	631,954,356
Net cash provided by financing activities	631,954,356
Net increase in cash and cash equivalents	509,835,903
Cash and cash equivalents, beginning of period	—
Cash and cash equivalents, end of period	$ 509,835,903
Schedule of non-cash investing and financing activities:	
Assessments receivable from participating insurers	$ 68,074,134

See accompanying notes to financial statements.

(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. 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. Given that activity in December 1996 was not significant, the accompanying financial statements include 13 months of operations.

The CEA is overseen by a three member governing board consisting of designees of the Governor, the Treasurer, and the Insurance Commissioner. Designees of the Speaker of the Assembly and the Chairperson of the Senate Rules Committee serve on the governing board as nonvoting members. The governing board is advised by an eleven 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 non-claims related operating costs incurred by these companies in servicing CEA policies. The operating cost reimbursement is equal to 3.65% 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, 1997, there were 12 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 generally accepted accounting principles. 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.

(Continued)

(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 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

The CEA accounts for investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. All of the CEA's investments are classified as available-for-sale securities and are carried at market value with the corresponding unrealized gains and losses included in equity. Declines in market value considered to be other than temporary are charged to operations. Gains and losses on sales of investments are determined 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 realizable value of such costs. The determination of estimated realizable 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) 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 retain the risk of earthquake losses on individual earthquake policies until the polices are 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

(Continued)

payable on the first day of each successive calendar month after the insurer begins to transfer risk of earthquake losses on individual earthquake polices 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, 1997, participating insurer capital contributions totaled $700,028,490, of which $68,074,134 were unfunded and are classified as assessments receivable in the accompanying financial statements.

(h) 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.

(i) 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.

(j) Equipment

Equipment is stated at cost less accumulated depreciation of $106,014. 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.

(k) Reinsurance

The CEA applies SFAS No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* to its reinsurance contracts. This statement establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. It also requires reinsurance receivables

(Continued)

(including amounts related to losses incurred but not reported) and prepaid reinsurance premiums to be reported as assets. Estimated reinsurance receivables are recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts.

(2) Investments and Fair Value of Financial Instruments

Interest income for the thirteen months ended December 31, 1997 was as follows:

Certificates of deposit	$	3,205,124
U.S. government money market accounts		541,975
Repurchase agreements		6,203,413
Commercial paper		43,791
Other short-term investments		7,877,170
Net interest income		17,871,473
Less investment expenses		(294,206)
Net investment income	$	17,577,267

The amortized cost and estimated fair value of U.S. agency security investments classified as available for sale at December 31, 1997 were $66,201,426 and $66,192,138, respectively. Gross unrealized gains and losses associated with these investments were $0 and $9,288 , respectively, at December 31, 1997. All of the U.S. agency security investments are due, by contractual maturity, within one year or less. Fair values for U.S. agency investments are based on quoted market prices.

Proceeds from maturities of available for sale U.S. agency security investments during the thirteen months ended December 31, 1997 were $784,714,624. There were no sales of available for sale investments during the thirteen months ended December 31, 1997.

The fair value of assessments receivable from participating insurers at December 31, 1997 of $64,738,879 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 $717,000,000 of loans and/or letters of credit through a credit agreement entered into with a consortium of banks administered by Chase Manhattan Bank. Available borrowings under this credit agreement 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. The CEA capitalized expenses relating to the arrangement of the line of credit, which it amortizes over the three year term of the contract. Prepaid line of credit fees associated with the arrangement fee are $3,112,887 as of December 31, 1997. The total amount of expense associated with the credit agreement, including arrangement, commitment, and administrative fees, was $3,793,213 during the period. There were no amounts outstanding under the line of credit as of December 31, 1997.

(4) Reinsurance

The CEA cedes insurance to reinsurers under two catastrophe excess of loss reinsurance contracts, for purposes of limiting its maximum exposure on any one loss. 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.

The first aggregate excess reinsurance contract is a 2 year contract, expiring December 31, 1998. The contract provides coverage of a minimum of $1.4 billion in excess of the CEA's claims paying ability, which may not exceed an amount equal to the $2 billion multiplied by the total residential property insurance market share of CEA's participating insurers of 71.681%. The second aggregate excess reinsurance contract is a 4 year contract, expiring March 31, 2001. The contract provides maximum coverage equal to $1.5 billion multiplied by the total residential property insurance market share of CEA's participating insurers of 71.681%. Both treaties provide coverage for losses as well as allocated loss adjustment expenses. No losses have been ceded as of December 31, 1997.

The contracts require the CEA to pay a minimum of non-refundable premiums of $835,979,663 payable in installments over the life of the contracts. The minimum payments remaining under these contracts as of December 31, 1997 are $482,054,725 and are due by October 1, 1998.

(5) Commitments and Contingencies

(a) Operating Lease

At December 31, 1997, the CEA occupied office space under an operating lease which extends to the year 2001, however this lease has a provision for early termination. The future minimum lease payments under the operating lease as of December 31, 1997, are as follows:

Years Ending December 31, 1998	$ 184,728
1999	184,728
2000	184,728
2001	146,243
	$ 700,427

Rental expense of approximately $204,000 for the thirteen months ended December 31, 1997 has been charged to operations in the accompanying statement of operations.

(b) Rate Hearing

The CEA is involved in various lawsuits and claims, of which include the *Matter of the Rate Hearing of the CEA*, and *Economic Empowerment Foundation v. California Department of Insurance and the California Insurance Commissioner; CEA, Real Party in Interest*. The CEA filed its rate application in November 1996, in anticipation of its beginning to sell policies on December 1, 1996. Although interim approval of the rates in the application was granted by the Insurance Commissioner, the application was subsequently contested by several intervenor groups. As a result of the intervention, the Department of Insurance (DOI) commenced a hearing on the CEA's rate application before an Administrative Law Judge in May 1997.

During the course of the hearing, the CEA voluntarily amended its rate application to reduce the contested rates by approximately 11.5%, effective November 1, 1997. In January 1998, the Administrative Law Judge issued a proposed decision, recommending rejection of the CEA's amended rate application, however the Insurance Commissioner subsequently reopened the record for comments until March 23, 1998, after which the Commissioner will have 60 days to render a decision.

The CEA believes that it is likely that the Commissioner's final decision will result in a retroactive reduction of rates and issuance of refunds on a portion of premiums collected since the CEA's inception. Accordingly, the CEA has recorded an accrued liability for policy refunds of $38,182,490 as of December 31, 1997. The accrued liability assumes an average refund of 11.5% on premiums received by the CEA since inception to October 31, 1997, and includes estimated amounts of interest expense and check issuance costs associated with the issuance of policy refunds.

Costs associated with the rate hearing, which include attorney fees, witness fees, and intervenor expenses, are expected to exceed $3,000,000. As of December 31, 1997, the CEA has incurred approximately $1,764,202 of these costs, which are included in other underwriting expenses in the accompanying financial statements.

(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 for the thirteen months ended December 31, 1997, totaled $11,008,823 and did not exceed 3% of premium income.

(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

(Continued)

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 approximately $72,133 during the thirteen months ended December 31, 1997.

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. The 1997 contribution accrued under the CEA Retirement Plan was $59,556 as of December 31, 1997.

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. At December 31, 1997, $5,800 of officers' compensation was deferred under the CEA Deferred Compensation Plan.

Schedule 1

CALIFORNIA EARTHQUAKE AUTHORITY

Schedule of Participating Insurer Assessments

Period from December 1, 1996 (inception) to December 31, 1997

	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	19,664,169
Liberty Mutual Insurance Company	6,812,984	5,563,937
California Fair Plan	15,029,487	—
California State Automobile Association	39,013,493	13,004,498
Preferred Risk	123,133	106,715
Automobile Insurance Exchange of Southern California	14,443,651	4,814,550
Armed Forces	783,685	666,132
CNA/Continental	13,924,609	11,835,917
Prudential Insurance Company	11,531,456	11,147,073
Mercury Insurance Company	1,292,688	1,271,143
Total	$ 700,028,490	68,074,134

See accompanying independent auditors' report.

CALIFORNIA EARTHQUAKE AUTHORITY

Schedule of Participating Insurer Premiums Written and Unearned

Period from December 1, 1996 (inception) to December 31, 1997

	Premiums Written	Unearned Premiums
Allstate Insurance Company	$ 122,012,844	71,949,159
Farmers Insurance Company	77,474,175	42,652,688
State Farm Insurance Company	119,938,789	75,016,301
United Services Automobile Association	32,705,984	23,520,253
Liberty Mutual Insurance Company	3,962,960	2,666,358
California Fair Plan	9,145,988	6,040,561
California State Automobile Association	9,200,175	6,243,329
Preferred Risk	24,028	16,510
Automobile Insurance Exchange of Southern California	9,815,445	7,060,015
Armed Forces	673,375	453,641
CNA/Continental	2,620,746	2,181,195
Prudential Insurance Company	547,672	523,616
Total	$ 388,122,181	238,323,626

See accompanying independent auditors' report.

CALIFORNIA EARTHQUAKE AUTHORITY

Schedule of Participating Insurer Commissions and Operating Costs

Period from December 1, 1996 (inception) to December 31, 1997

		Commissions	Operating Costs
Allstate Insurance Company	$	5,013,421	1,803,817
Farmers Insurance Company		3,488,273	1,255,197
State Farm Insurance Company		4,501,759	1,619,425
United Services Automobile Association		920,056	330,709
Liberty Mutual Insurance Company		129,899	46,751
California Fair Plan		310,811	111,863
California State Automobile Association		295,958	106,507
Preferred Risk		756	274
Automobile Insurance Exchange of Southern California		276,115	99,239
Armed Forces		21,999	7,926
CNA/Continental		44,003	15,841
Prudential Insurance Company		2,410	867
Total	$	15,005,460	5,398,416

See accompanying independent auditors' report.