STATE COMPENSATION INSURANCE FUND

Statutory Basis Financial Statements

December 31, 2012 and 2011

(With Independent Auditors' Report Thereon)

KPMG LLP
Suite 1400
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

The Board of Directors
State Compensation Insurance Fund:

We have audited the accompanying financial statements of State Compensation Insurance Fund, which comprise the statutory statements of admitted assets, liabilities, and policyholders' surplus as of December 31, 2012 and 2011, and the related statutory statements of operations and changes in policyholders' surplus, and cash flow for the years then ended, and the related notes to the statutory financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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 from material misstatement.

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

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

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

As described in note 2 to the financial statements, the financial statements are prepared by State Compensation Insurance Fund using statutory accounting practices prescribed or permitted by the California Department of Insurance, which is a basis of accounting other than U.S. generally accepted accounting principles. Accordingly, the financial statements are not intended to be presented in accordance with U.S. generally accepted accounting principles.

The effects on the financial statements of the variances between the statutory accounting practices described in note 2 and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the variances between statutory accounting principles and U.S. generally accepted accounting principles discussed in the Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles paragraph, the financial statements referred to above do not present fairly, in accordance with U.S. generally accepted accounting principles, the financial position of State Compensation Insurance Fund as of December 31, 2012 and 2011, or the results of its operations or its cash flows for the years then ended.

Opinion on Statutory Basis of Accounting

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of State Compensation Insurance Fund as of December 31, 2012 and 2011, and the results of its operations and its cash flow for the years then ended, in accordance with statutory accounting practices prescribed or permitted by the California Department of Insurance described in note 2.

Emphasis of Matter

As discussed in note 10 to the financial statements, as of December 31, 2012, State Compensation Insurance Fund established a special surplus fund for the estimated unfunded pension and other postemployment benefits contingency. Our opinion is not modified with respect to this matter.

Other Matter

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The supplementary information included on the supplemental investment risk interrogatories (Schedule I), supplemental summary investment schedules (Schedule II) and reinsurance interrogatory is presented for purposes of additional analysis and is not a required part of the financial statements but is supplementary information required by the California Department of Insurance. Such information is the responsibility of management and was derived from and relates 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 audits 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.

/s/KPMG LLP

San Francisco, CA
May 10, 2013

STATE COMPENSATION INSURANCE FUND

Statements of Admitted Assets, Liabilities, and Policyholders' Surplus
(Statutory Basis)

December 31, 2012 and 2011

(In thousands)

Admitted Assets		2012	2011
Bonds, at amortized cost	$	18,232,852	18,940,254
Real estate		353,544	360,189
Cash, cash equivalents, and short-term investments		430,904	130,128
Receivables for securities		2,035	598
Total cash and investments		19,019,335	19,431,169
Premiums in the course of collection		38,299	27,027
Deferred, earned but unbilled, and accrued retrospective premiums		53,342	33,457
Reinsurance recoverables		3,122	5,319
Accrued interest and dividends		151,213	166,707
Guaranty fund receivables		73,453	96,934
Due from adjusting contracts		34,153	39,206
Other assets		61,201	73,086
Total admitted assets	$	19,434,118	19,872,905
Liabilities and Policyholders' Surplus			
Estimated liabilities for:			
Losses	$	11,193,897	11,996,219
Loss adjustment expenses		1,732,627	2,036,427
Retroactive reinsurance ceded		(528,997)	(597,041)
Unearned premiums		47,026	60,051
Dividends reserve		131,182	50,500
Other post employment benefit liability		490,723	390,440
Other liabilities		355,791	273,617
Total liabilities		13,422,249	14,210,213
Special surplus funds for:			
Retroactive reinsurance		528,997	576,256
Unfunded pension and other post employment benefit		1,009,277	—
Unassigned surplus		4,473,595	5,086,436
Policyholders' surplus		6,011,869	5,662,692
Total liabilities and policyholders' surplus	$	19,434,118	19,872,905

See accompanying notes to statutory basis financial statements.

STATE COMPENSATION INSURANCE FUND

Statements of Operations and Changes in Policyholders' Surplus
(Statutory Basis)

Years ended December 31, 2012 and 2011

(In thousands)

		2012	2011
Net premiums earned	$	922,635	1,001,629
Losses incurred		691,975	252,381
Loss adjustment expenses incurred		207,593	928,300
Underwriting and administrative expenses		356,588	401,079
Total underwriting deductions		1,256,156	1,581,760
Net underwriting loss		(333,521)	(580,131)
Net investment income earned		759,610	829,176
Net realized capital gains		42,821	27,945
Other loss		(10,733)	(97,857)
Net income before dividends to policyholders		458,177	179,133
Dividends to policyholders		99,500	49,501
Net income		358,677	129,632
Policyholders' surplus, beginning of year		5,662,692	5,466,363
Change in nonadmitted assets		(11,329)	61,042
Change in provision for reinsurance		1,829	5,655
Policyholders' surplus, end of year	$	6,011,869	5,662,692

See accompanying notes to statutory basis financial statements.

STATE COMPENSATION INSURANCE FUND

Statements of Cash Flow
(Statutory Basis)

Years ended December 31, 2012 and 2011

(In thousands)

		2012	2011
Premiums collected net of reinsurance	$	833,018	950,053
Net investment income		843,182	875,070
Other income received		25,308	13,424
Benefits and loss-related payments		(1,492,100)	(1,417,949)
Other underwriting expenses		(857,121)	(839,191)
Net cash used in operations		(647,713)	(418,593)
Proceeds from investments sold, matured, or repaid:			
Bonds		4,862,996	3,839,048
Real estate		10,895	44,774
Short-term investments and other		—	2,241
Cost of investments acquired:			
Bonds		(4,170,670)	(4,425,115)
Real estate		(14,180)	(15,870)
Miscellaneous		(1,437)	—
Net cash provided by (used in) investments		687,604	(554,922)
Other cash provided		260,885	76,357
Net cash provided by financing and miscellaneous sources		260,885	76,357
Net change in cash, cash equivalents, and short-term investments		300,776	(897,158)
Cash, cash equivalents, and short-term investments, beginning of year		130,128	1,027,286
Cash, cash equivalents, and short-term investments, end of year	$	430,904	130,128

See accompanying notes to statutory basis financial statements.

(1) History and Business

State Compensation Insurance Fund (State Fund) is a public enterprise fund established by the State of California through legislation enacted in 1913 to provide an available market for workers' compensation insurance to employers located in California. The State of California is not liable for any obligations of State Fund.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The statutory basis financial statements of State Fund have been prepared in conformity with accounting practices prescribed or permitted by the California Department of Insurance (CDI), and in accordance with the National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures Manual*, to the extent those practices and procedures do not conflict with the California Insurance Code.

Statutory accounting practices differ in certain respects from the U.S. generally accepted accounting principles, as prescribed by the Governmental Accounting Standards Board (GASB). The significant differences from GASB are as follows:

- The net amount of all cash accounts is reported jointly and in instances of a net negative cash balance, amounts are reported as a negative asset rather than liability.
- Investment in bonds and short-term investments are carried principally at amortized cost, whereas under GASB such investments would be carried at estimated fair value with changes in fair value reflected in net income.
- Policy acquisition costs, including commissions and premium taxes, are charged to current operations as incurred, whereas related premium income is recognized on a pro rata basis over the periods covered by the policies. Under GASB, policy acquisition costs would be deferred and amortized to income on the same basis as premium income is recognized.
- Certain assets designated as "nonadmitted assets" are excluded from total assets. These assets, the change in which is credited or charged directly to policyholders' surplus, consist primarily of the following: premiums in the course of collection, which remain outstanding over 90 days, plus all related amounts due that have been recorded on those policies; nonoperating system internally developed software costs; 10% of earned but unbilled premiums (EBUB) in excess of collateral specifically held and identifiable on a per policy basis; 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party or collateral; office furniture and equipment; and prepaid expenses. Under GASB, these assets would be included in total assets to the extent realizable.
- Gains on the retroactive reinsurance contract are recognized in income and established as segregated surplus. GASB requires the gains to be deferred and recognized over the estimated settlement period of the reinsured losses, using either a recovery or interest method.

- Fees received for processing the claims of other self-insured State of California departments are netted against loss adjustment expenses, whereas under GASB, they are recorded as other income.
- An allocation of rental value to space owned and occupied by State Fund is included in income and expense, whereas it is excluded under GASB.
- The statement of cash flows differs in certain respects from the presentation required by GASB, including the presentation of the changes in cash, cash equivalents, and short-term investments, instead of cash and cash equivalents. Short-term investments include securities with maturities, at the time of acquisition, of one year or less. In addition, there is no reconciliation between net income and cash from operations as there would be under GASB.
- A provision for reinsurance is recorded as a liability with a corresponding adjustment to policyholders' surplus for the reinsurance receivable from unauthorized reinsurance carriers with inadequate collateral, and reinsurance recoverable over 90 days, plus all related amounts due that have been recorded on those reinsurance recoverable. Under GASB, such a provision for reinsurance is not recognized.

(b) Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with statutory accounting principles permitted or prescribed by the CDI requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. Among the most significant estimates inherent in these statutory financial statements are the liabilities for losses and loss adjustment expenses (see note 2(f)), and State Fund's portion of the pension and other postemployment benefit (OPEB) cost estimated by the State Controller's office based on the current actuarial valuation prepared for the State of California (see note 2(j)).

(c) Cash, Cash Equivalents, and Short-Term Investments

Cash consists of cash in banks. Also classified as cash for financial statement purposes are savings accounts and certificates of deposit in banks or other similar financial institutions with maturity dates within one year or less from the acquisition date, and cash equivalents. Cash equivalents are short-term, highly liquid investments with original maturities of three months or less that are both (a) readily convertible to known amounts of cash and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Short-term investments are those investments when originally acquired had maturities of one year or less.

(d) Investments

Investments in bonds are valued in accordance with the requirements of the Securities Valuation Office of the NAIC. Bonds are generally stated at amortized cost, except bonds that are defined by the NAIC as Class 3 through 6, which are stated at the lower of amortized cost or fair value. Amortization is calculated using the scientific constant yield to worst method. Mortgage-backed

securities (MBS) are amortized using anticipated prepayments and are accounted for using the prospective method.

The carrying value for MBS has been determined in accordance with the guidelines of the NAIC. Fair value is primarily determined using a pricing hierarchy starting with a widely accepted pricing vendor, followed by State Fund's custodial Bank, portfolio managers' independent pricing services, and other pricing services.

State Fund uses widely accepted cash flow models from third-party data providers, which uses Median Speeds. Median Speeds is a model that serves as a benchmark for MBS prepayment assumptions. This model looks to the specifics of the security dealers' models. When median assumptions are used for analysis, the data provider will scan all of the median security dealers' prepayment assumptions and choose the speed in the middle.

Declines in the value of investments that are determined to be other than temporary result in a reduction in carrying amount to fair value, or, for MBS's, to the present value of expected cash flows if management has the ability and intent to hold the MBS to recovery of that amount. The impairment charge is included as a realized loss and a new cost basis for the security is established. To determine whether an impairment is "other than temporary," State Fund considers many factors including credit quality, market analysis, current events, probability of recovery, and management's intent and ability to hold the asset.

Investment expenses consist primarily of expenses incurred in the investing of funds and pursuit of investment income. Such expenses include custodial expenses, portfolio management, and advisory fees for the short-and long-term bonds; alteration to property, repairs and maintenance, utilities, real estate taxes, and other real property expenses for real estate investments.

(e) Real Estate, Furniture, and Equipment

Real estate consists primarily of office buildings occupied by State Fund and is stated at cost less accumulated depreciation. Real estate held for sale is carried at the lower of depreciated cost or fair value less estimated cost to sell. Depreciation on buildings is computed on a straight-line basis over the estimated useful lives of the buildings (50 years).

Data processing equipment and capitalized internally developed software are carried at cost less accumulated depreciation computed on a straight-line basis over the estimated useful lives of the assets (three years). Depreciation on office furniture and equipment is computed on a straight-line basis over the estimated useful lives of the assets (five years). The aggregate amount of admitted data processing equipment (net of accumulated depreciation) is limited to 3% of State Fund's policyholders' surplus, adjusted for the carrying value of data processing equipment.

The cost of assets retired or otherwise disposed of, and the related accumulated depreciation thereon, are removed from the accounts with any gain or loss realized upon sale or disposal, credited or charged to operations. The nonadmitted assets consist primarily of nonoperating system internally developed software costs.

(f) Losses and Loss Adjustment Expenses

Management records its best estimate of losses and loss adjustment expenses. These liabilities include: the estimated future cost of reported claims, the cost of claims incurred but not reported, and expenses related to investigating and settling claims. State Fund does not discount these liabilities. These liabilities are based on actuarial estimates that are subject to considerable uncertainty. Should State Fund's losses develop in the future differently from their historical loss development or those projected by the actuarial methods, actual losses would vary, perhaps significantly, from such actuarial estimates. Any adjustments to these estimates are reflected in operations when known (see note 7).

Management's estimates are based on its knowledge and experience about past and current events and circumstances, and its assumptions about conditions it expects to exist in the future. Factors relevant to the estimation of losses and loss adjustment expense liabilities include the estimation of the ultimate frequency and severity of losses, the level of future medical cost inflation over long periods of time, the future legal and regulatory environment, and the amount of future expenses required to investigate and settle claims. Management's estimates are reviewed quarterly by a nationally recognized consulting actuarial firm (the Appointed Actuary). The Appointed Actuary is retained in accordance with CDI regulatory provisions as the designee to issue a statement of actuarial opinion that has been reviewed with the board of directors as required by actuarial standards of practice.

State Fund establishes full case reserves for all reported asbestos and environmental claims. Incurred but not reported (IBNR) reserves are established on the book as a whole and include a provision for development of reserves on reported losses. State Fund's aggregate reserves are established based on in-house analyses, and input from external actuaries using a variety of reserve techniques, including paid loss development, incurred loss development, Berquist-Sherrman adjustment counts and averages, and historical loss ratios adjusted to current rate levels.

(g) Revenue Recognition and Unearned Premiums

State Fund applies the "Western Accounting Method" in which direct written premium is recognized when billed to the policyholder. Insurance premiums are recognized as earned ratably over the term of the policies, that is, in proportion to the amount of insurance protection provided. The portion of the premiums that will be earned in the future is deferred and reported as unearned premiums.

In 2012, State Fund implemented new billing terms that changed the nature of deposits for a majority of State Fund policies. Required deposits are billed to policyholders based on a percentage of estimated annual premiums and recorded as a deposit liability. Subsequent premium bills are recorded as premiums written and earned pro rata over the policy term. Unearned premiums are established to cover the unexpired portion of premiums written. State Fund records an estimate for EBUB as a direct adjustment to earned premiums. Amounts in excess of the 10% of EBUB not anticipated to be collected are written off against operations in the period that the determination is made. As of December 31, 2012, State Fund reported deposit liability of $101,298.

A premium deficiency liability is recognized if the sum of anticipated losses and loss adjustment expenses, maintenance costs, and any acquisition costs not previously expensed, less anticipated investment income, exceed the recorded unearned premium. As of December 31, 2012 and 2011, State Fund has no liabilities related to premium deficiency reserves. State Fund considers anticipated investment income when determining the existence of a premium deficiency.

(h) Reinsurance

Reinsurance recoverables on paid losses and loss adjustment expenses (LAE) are reported as assets. Estimated reinsurance recoverables on unpaid losses and LAE are recognized in a manner consistent with the liabilities related to the underlying reinsured contracts.

(i) Guaranty Fund and Other Assessments

In California, all insurers writing workers' compensation, including State Fund, are subject to assessment by the California Insurance Guarantee Association (CIGA) and the Department of Industrial Relations (DIR) to protect claimants against insurer insolvencies and administer various aspects of the workers' compensation system. The 2012 and 2011 annual CIGA assessment was 2.285% and 2.559%, respectively, of direct written premium. The DIR assessment aggregates to approximately 1.96% and 2.97% of direct written premium for 2012 and 2011, respectively. Annual assessments are paid in advance, based on prior year premiums with the final assessment based on reported calendar year written premium. Additional amounts owed are included in the guaranty fund assessments liability and the DIR assessments are included in other liabilities. Amounts prepaid in excess of the final assessment amount are available for credit against future assessments and included in guaranty fund receivables.

In California, all insurers are required by law to bill their policyholders a premium surcharge to cover such fund assessments. State Fund generally requires the policyholder to pay an estimated surcharge at policy inception. The surcharge relating to unexpired coverage is included in the guaranty fund assessments liability and the DIR assessments are included in other liabilities. Additional surcharges owed by policyholders are included in guaranty fund receivables and the DIR assessments are included in other assets. State Fund remains liable to assessing agencies should policyholders fail to remit premium surcharges.

State Fund expects to fund CIGA for guaranty fund assessments for at least the next year at a rate of 2% of future direct premiums written. Based on information currently available, State Fund expects to continue to be obligated to fund CIGA annually, at rates that are determined and announced annually.

Under the U.S. Longshoremen's and Harbor Workers' (L&H) Compensation Act (the Act), all carriers and self-insurers writing U.S. L&H policies, including State Fund, are required to make payments into a Special Fund based on a pro rated assessment determined by the Secretary of the U.S. Department of Labor. The Special Fund was created to protect injured employees or their survivors by providing for subsequent injuries as defined by the Act. State Fund recorded a liability of $9,268 and $10,000 included in the "other liabilities" account as of December 31, 2012 and 2011, respectively, for future assessments under the Act.

(j) Pension and Other Postemployment Benefit Plans

State Fund employees are employees of the State of California (the State). Consequently, State Fund employees participate in the State pension and OPEB plans. State Fund is not directly liable for obligations under the plans.

The State employee pension plan is administered by the Public Employees' Retirement System of the State of California (CalPERS). State Fund pays CalPERS the estimated employers' share of its current employees' retirement cost solely based on assessments computed by CalPERS.

The State's OPEB plan provides medical, prescription drug, and dental benefits (healthcare benefits) to retired statewide employees. The authority for establishing and amending the OPEB plan lies with CalPERS, while the authority for establishing and amending the funding policy lies with the State Legislature. The State's OPEB plan is a single-employer defined-benefit plan. A separate actuarial valuation was not performed for State Fund.

The State's annual OPEB cost is calculated based on the annual required contribution (ARC) of the employer, an amount actuarially determined by the State in accordance with the parameters of GASB No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years. The State determines the annual allocation for State Fund based upon the relationship of active employee health benefit costs for State Fund as compared to the total State active employee health benefit costs. State Fund has been recording its additional share (per GASB 45) of the annual OPEB cost since December 2008 and carries the accumulated balance (i.e., the allocated amount less the amount State Fund has funded to the State) as a liability. State Fund continues to pay on a "pay-as-you-go" funding policy.

Projection of benefits for financial reporting purposes is based on the substantive plan and includes the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between employer and plan members to that point. The actuarial calculations reflect a long-term perspective. Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future. Actuarially determined amounts are subject to continual revisions as results are compared to past expectations and new estimates are made about the future. All actuarial methodology, assumptions, and results discussed herein were provided to State Fund by the State of California.

The State's Unfunded Actuarial Accrued Liabilities for the pension and OPEB plans are based on a variety of actuarial assumptions as disclosed in the State's Comprehensive Annual Financial Report (CAFR). Separate actuarial valuations related to State Fund are not available. As a result, the portion of the State's unfunded pension and OPEB liabilities attributable to State Fund is not known, and will change over time.

Based on information provided to State Fund by the State of California, in the June 30, 2012 actuarial valuation, the individual entry-age normal cost method was used. A pay-as-you-go funding

scenario was used by the State of California. Under the pay-as-you-go funding scenario, the State is assumed to finance retiree healthcare benefits from assets available in the general fund. The State's actuarial assumptions included a discount rate of 4.5%, and an annual healthcare cost trend rate of 9% initially, decreasing each year over the next seven years until the ultimate rate of 4.5% is reached.

Funding progress information specifically related to State Fund's portion of the statewide OPEB plan is not available. For more details about the actuarial methods and assumptions used by the State as well as the statewide plans funding progress and status, refer to the State's CAFR for the fiscal year ended 2012.

(k) Income Taxes

State Fund is exempt from income taxation under the Internal Revenue Code. State Fund pays premium taxes to the State of California.

(l) Reclassifications

Certain reclassifications have been made to 2011 to conform to the 2012 presentation.

(3) Risk-Based Capital

California law imposes risk-based capital (RBC) requirements on admitted California insurance companies, including State Fund. These RBC requirements set forth a calculation to determine the required levels of policyholders' surplus, and provide certain consequences for failure to meet these requirements. State Fund operates in conformity with the California law imposed for RBC. As of December 31, 2012 and 2011, policyholders' surplus exceeded the minimum RBC requirements.

(4) Investment Securities

The amortized cost, which is reported as the admitted value and estimated fair value of investments in bonds as of December 31, 2012 and 2011 are as follows:

	2012			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
NAIC General Category:				
All other governments	$ 228,534	22,581	—	251,115
Industrial and miscellaneous	5,778,161	461,154	(2,562)	6,236,753
Political subdivisions	291,978	50,549	—	342,527
Special revenue/assesment	8,597,273	678,675	(1,503)	9,274,445
States territories and possessions	351,890	56,244	—	408,134
U.S. government	2,985,016	285,450	(80)	3,270,386
Totals	$ 18,232,852	1,554,653	(4,145)	19,783,360

	2011			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
NAIC General Category:				
All other governments	$ 279,346	22,984	—	302,330
Industrial and miscellaneous	5,026,599	343,157	(17,600)	5,352,156
Political subdivisions	261,730	30,724	—	292,454
Special revenue/assesment	8,537,696	644,510	(3,192)	9,179,014
States territories and possessions	338,054	42,845	—	380,899
U.S. government	4,496,829	399,671	—	4,896,500
Totals	$ 18,940,254	1,483,891	(20,792)	20,403,353

State Fund reviews its investment portfolio to determine whether or not declines in fair value of individual securities held are other than temporary. In addition to average cost and fair value, factors including credit quality, market analysis, current events, and management's judgment are used to determine whether securities are considered other than temporarily impaired. As of December 31, 2012 and 2011, 60 and 33 securities were in an unrealized loss position, which resulted in an unrealized loss of $4,145 and $20,792, respectively. The unrealized loss position at the end of 2012 was due to combination of the general increase in interest rates going into year-end as well as the change in the risk premium over the risk-free rate of some securities. State Fund's Chief Investment Officer, Investment Team, and Portfolio Managers actively manage State Fund's investment risk by meeting weekly to discuss credit and default risk in addition to short–and long-term investment strategies. Additionally, State Fund's investment department independently monitors rating changes on its entire portfolio daily followed by weekly discussions as appropriate. As of December 31, 2012, 99% of all bonds held by State Fund were rated Class 1 by the NAIC. State Fund concluded that the gross unrealized losses of $4,145 as of December 31, 2012 were temporary in nature.

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2012 and 2011:

	2012								
	12 Months or under			Over 12 months			Total		
	Fair value	Amortized cost	Gross unrealized losses	Fair value	Amortized cost	Gross unrealized losses	Fair value	Amortized cost	Gross unrealized losses
Industrial and miscellaneous	$ 287,800	290,362	(2,562)	—	—	—	287,800	290,362	(2,562)
Special revenue/ assesment	347,567	348,823	(1,256)	4,380	4,627	(247)	351,947	353,450	(1,503)
U.S. government	15,640	15,720	(80)	—	—	—	15,640	15,720	(80)
Totals	$ 651,007	654,905	(3,898)	4,380	4,627	(247)	655,387	659,532	(4,145)

	2011								
	12 Months or under			Over 12 months			Total		
	Fair value	Amortized cost	Gross unrealized losses	Fair value	Amortized cost	Gross unrealized losses	Fair value	Amortized cost	Gross unrealized losses
Industrial and miscellaneous	$ 418,733	436,333	(17,600)	—	—	—	418,733	436,333	(17,600)
Special revenue/ assesment	77,031	77,614	(583)	47,376	49,985	(2,609)	124,407	127,599	(3,192)
U.S. government	—	—	—	—	—	—	—	—	—
Totals	$ 495,764	513,947	(18,183)	47,376	49,985	(2,609)	543,140	563,932	(20,792)

The amortized cost and estimated fair value of bonds as of December 31, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	2012	
	Amortized value	Estimated fair value
Due in one year or less	$ 1,031,932	1,046,081
Due after one year through five years	3,916,098	4,283,521
Due after five years through ten years	4,137,494	4,535,167
Due after ten years	1,990,649	2,288,526
Mortgage-backed securities	7,156,679	7,630,065
Totals	$ 18,232,852	19,783,360

Proceeds from sales of investments in bonds during 2012 were $912,782 with gross realized gains of $39,669 and gross realized losses of $2,915.

The amortized cost and estimated fair value of bonds as of December 31, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	2011	
	Amortized value	Estimated fair value
Due in one year or less	$ 1,529,152	1,552,387
Due after one year through five years	3,997,946	4,285,711
Due after five years through ten years	4,267,041	4,691,592
Due after ten years	1,242,578	1,408,097
Mortgage-backed securities	7,903,537	8,465,566
Totals	$ 18,940,254	20,403,353

Proceeds from sales of investments in bonds during 2011 were $625,194 with gross realized gains of $13,745 and gross realized losses of $52.

State Fund recognized no other-than-temporary impairment in bonds for the years ended December 31, 2012 and 2011.

In 2012, State Fund's gross investment income was $820,235 less applicable expense of $60,625 resulting in $759,610 net investment income earned. In 2011, State Fund's gross investment income was $891,291 less applicable expense of $62,114 resulting in $829,177 net investment income earned.

State Fund's investment policies limit concentration of credit risk by requiring diversification of its investments in any one issuer, industry, or geographic region. Per California Insurance Code Section 11788, the State Treasurer's Office is the custodian of State Fund's long-term investment holdings.

State Fund had $67,061 and $66,707 on deposit with the Federal Reserve Bank of Philadelphia to satisfy the U.S. Department of Labor regulations relating to State Fund's issuance of U.S. L&H policies as of December 31, 2012 and 2011, respectively.

State Fund does not engage in subprime residential mortgage lending nor does it invest directly in subprime fixed income securities. As of December 31, 2012, State Fund has no direct subprime mortgage-related risk exposure. However, State Fund does invest in Aaa/AA+ rated MBS that are backed by government agencies or government-sponsored entities, specifically Ginnie Mae, Fannie Mae, and Freddie Mac. These types of securities are collateralized by loans but are ultimately backed by the issuing agency. Ginnie Mae securities are guaranteed by the U.S. Treasury and on December 25, 2009, Fannie Mae and Freddie Mac were granted unlimited financial assistance by the U.S. Treasury through 2012.

State Fund as well as other State Agencies and Local Agencies are authorized to invest funds in the State of California's Pooled Money Investment Account (PMIA). State Fund's holdings in the PMIA at December 31, 2012 were $16,694.

(5) Fair Value of Financial Instruments

The carrying value of short term investments approximates fair value due to the short maturities of these investments. State Fund has no assets or liabilities measured at fair value on a recurring basis as of December 31, 2012 and 2011. During 2011 and 2012, State Fund did not have any material nonrecurring fair value measurement of financial or nonfinancial assets or liabilities carried at fair value.

State Fund categorizes its financial instruments into a three-level hierarchy based on the priority of the inputs to the valuation technique per SSAP No. 100. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument in its entirety.

Level 1 – Quoted prices in active markets for identical assets or liabilities

Level 2 – Inputs, other than quoted prices, that are observable by a marketplace participant, either directly or indirectly

Level 3 – Unobservable inputs that are significant to the fair value measurement.

	December 31, 2012			
	Level 1	Level 2	Level 3	Total
NAIC general category:				
All other governments	$ —	251,115	—	251,115
Industrial and miscellaneous	—	6,229,699	7,054	6,236,753
Political subdivision	—	342,527	—	342,527
Special revenue/assessment	—	9,274,445	—	9,274,445
States territories and possessions	—	408,134	—	408,134
U.S. government	—	3,270,386	—	3,270,386
Totals	$ —	19,776,306	7,054	19,783,360

	December 31, 2011			
	Level 1	Level 2	Level 3	Total
NAIC general category:				
All other governments	$ —	302,330	—	302,330
Industrial and miscellaneous	—	5,344,452	7,704	5,352,156
Political subdivision	—	292,454	—	292,454
Special revenue/assessment	—	9,179,014	—	9,179,014
States territories and possessions	—	380,899	—	380,899
U.S. government	—	4,896,500	—	4,896,500
Totals	$ —	20,395,649	7,704	20,403,353

Bonds categorized as Levels 2 and 3 were valued using market approach. This method uses prices and other relevant information generated by market transactions involving identical or comparable assets.

At the end of each reporting period, State Fund evaluates whether or not any event has occurred or circumstances have changed that would cause an instrument to be transferred between Levels 2 and 3.

Following is the rollforward of Level 3 item:

Description	Balance, January, 1 2012	Transfers into Level 3	Transfers out of Level 3	Total gains (losses) included in net income	Purchases, issuances, sales and settlement	Balance, December 31, 2012
Industrial and miscellaneous	$ 7,704	—	—	650	—	7,054
Total	$ 7,704	—	—	650	—	7,054

(6) Real Estate, Furniture, and Equipment

Real estate as of December 31, 2012 and 2011 comprises the following:

		2012	2011
Property occupied by the company	$	410,426	439,274
Property held for sale		32,172	10,299
		442,598	449,573
Accumulated depreciation		(89,054)	(89,384)
Totals	$	353,544	360,189

Depreciation expense on real estate was $10,226 and $9,507 for the years ended December 31, 2012 and 2011, respectively. Certain real estate properties owned were sold and impaired due to significant decrease in appraised value and intent to sell. As of December 2012, State Fund realized a capital gain of $1,161 on sale of real estate properties. As of December 2011, State Fund realized a capital gain of $24,555 and a capital loss of $375 for a net realized capital gain of $24,180 on sale of real estate properties. As of December 2012 and 2011, State Fund impaired real estate properties, which resulted in a loss of $866 and $9,929, respectively, recorded as part of the net realized capital gain (loss).

Furniture and equipment as of December 31, 2012 and 2011 comprise the following:

		2012	2011
Data processing equipment and software	$	119,636	114,262
Office furniture and equipment		212,831	199,457
		332,467	313,719
Accumulated depreciation		(299,609)	(281,029)
		32,858	32,690
Nonadmitted assets		(28,190)	(31,383)
Totals	$	4,668	1,307

Depreciation expense on furniture and equipment was $18,580 and $22,190 for the years ended December 31, 2012 and 2011, respectively.

(7) Estimated Liabilities for Losses and Loss Adjustment Expenses

The table below reflects changes in the estimated liabilities for losses and loss adjustment expenses over the prior 12 months through December 31, 2012 and 2011. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of a loss portfolio transfer.

		2012	2011
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of $170,524 and $232,190, respectively	$	14,032,646	15,052,775
Add incurred related to:			
Current year		883,820	998,506
Prior years		15,748	182,175
Total incurred		899,568	1,180,681
Less paid related to:			
Current year		73,396	78,283
Prior years		1,932,294	2,122,527
Total paid		2,005,690	2,200,810
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of $142,466 and $170,524, respectively	$	12,926,524	14,032,646

Incurred losses and loss adjustment expenses relating to insured events in prior years were approximately $15,748 and $182,175 in 2012 and 2011, respectively. Prior year incurred is attributable primarily to the strengthening of loss adjustment expenses, due to a continued decline in closing rates running off claims inventory in face of increasing litigation and Medicare set-aside requirements. The 2012 incurred related to prior years is immaterial and primarily attributable to adverse development in U.S. L&H business.

State Fund writes workers' compensation insurance, a line that exposes State Fund to long-term liabilities with a potential for significant reserve variability. Management has identified the major risk factors in reserve estimation as the growth and contraction of business written by State Fund in recent years, recently enacted legislative changes affecting the line of business (i.e., reform), exposure to the retroactive impact of future legislative, regulatory and judicial decisions (latest Ogilvie/Almaraz Guzman cases), medicare set-aside requirement, and medical inflation.

State Fund had a significant increase in business volume during the 2002 – 2003 calendar years. Following that period of growth, a significant number of accounts returned to the private insurance market during the 2005 – 2011 period. This growth and contraction of business changed the mix of business over time, impacting development patterns, and contributing an element of uncertainty to loss reserve projections.

Also, in November 2003, the California Legislature passed Assembly Bill 227 and Senate Bill 228, representing a major reform of the workers' compensation system. This was followed in April 2004 by the

further reforms of Senate Bill 899. These bills provide for major changes in benefit levels and the administration of claims, impacting both new claims and open claims from earlier accident years. Management has considered the impact of these reforms in estimating future liabilities; however, the breadth of the changes and their impact on loss development patterns, and the potential for future legislative, regulatory, or judicial decisions to retroactively impact currently estimated liabilities add a level of uncertainty to a current estimate of future liabilities. In August 2012, Senate Bill 863 was passed. The bill makes wide-ranging changes to California's workers' compensation system, including increased benefits to injured workers and cost-saving efficiencies. The bill became effective January 1, 2013.

Finally, the workers' compensation benefit program provides medical care for the lifetime of the claimant in some cases. This exposes any current estimate of future liability to the uncertainties of future medical inflation.

These risk factors, coupled with the variability that is inherent in any reserve estimate, could result in material adverse deviation from the carried estimated liabilities for losses and loss adjustment expenses.

As a workers' compensation carrier, State Fund has incidental exposure to asbestos and environmental claims. Given that State Fund's book is principally small to medium size businesses, State Fund has no significant asbestos and environmental exposure aggregations. Asbestos and environmental claims are handled in the routine course of business. Claims are made up on a per claimant basis. At December 31, 2012, State Fund identified 960 open asbestos cases with aggregate outstanding case reserves of $27,849, or an average outstanding case reserves of approximately $28.6 per claim. At December 31, 2011, State Fund identified 1,315 open asbestos cases with aggregate outstanding case reserves of $28,000, or an average outstanding case reserves of approximately $21.3 per claim.

The table below reflects the amount paid and reserved for losses and loss adjustment expenses for asbestos claims on direct, assumed, and net of reinsurance basis:

		2012	2011
(1) Asbestos, direct:			
a. Beginning reserves (including case, bulk and IBNR, and LAE)	$	56,643	57,215
b. Losses and LAE incurred		3,984	4,196
c. Calendar year payments for losses and LAE		(5,407)	(4,768)
d. Ending reserves (including case, bulk and IBNR, and LAE)	$	55,220	56,643
(2) Asbestos, assumed	$	—	—
(3) Asbestos, net:			
a. Beginning reserves (including case, bulk and IBNR, and LAE)	$	54,013	54,585
b. Incurred losses and loss adjustment expenses		2,724	4,196
c. Calendar year payments for losses and LAE		(5,407)	(4,768)
d. Ending reserves (including case, bulk and IBNR, and LAE)	$	51,330	54,013

State Fund requires the insurance companies that underwrite structured settlement annuities to have an A.M. Best credit rating of A+ or better and $8 billion dollars or more in total assets at the time of purchase. The total amount of loss reserves no longer carried due to the purchase of annuities, with the claimant as payee, was $726,259 and $579,545 as of December 31, 2012 and 2011, respectively. State Fund remains liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities.

Loss reserves eliminated by annuities issued by the following companies exceeded 1% of policyholders' surplus as of December 31, 2012 and 2011:

		2012	2011
Genworth Life and Annuity Insurance, Richmond, VA	$	94,327	95,719
Hartford Life Insurance Co., Windsor, CT		104,281	106,943
Aviva Life Insurance Company, West Des Monies, IA		96,708	97,896
Pacific Life Insurance Co., Newport Beach, CA		140,265	—
Metlife Life Insurance Company, Tampa, FL		116,502	87,176
Totals	$	552,083	387,734

(8) Reinsurance

For the years ended December 31, 2012 and 2011, total earned premiums ceded under the reinsurance contracts were $16,161 and $15,801, respectively.

Based upon the estimated reinsurance recoverable under reinsurance treaties for years 1968 through 1982, 1985, and 1988 through 2004, State Fund's liabilities for losses were reduced by $142,466 and $170,524 as of December 31, 2012 and 2011, respectively, including $68,006 and $44,915 recoverable from Munich Reinsurance America, Inc. and Reliastar Life Insurance Co as of December 31, 2012, and $65,549 and $42,087 from Munich Reinsurance America Inc., and Reliastar Life Insurance Co as of December 31, 2011.

(a) Catastrophic Reinsurance

State Fund's underwriting risk exposure is concentrated in California. As such, State Fund is exposed to earthquakes, terrorist acts, and other catastrophic events. These have not had significant adverse effects on operations in the past, but could present risks in the future. State Fund purchases reinsurance protection to mitigate losses from catastrophic events.

State Fund cedes insurance risk relating to its workers' compensation business on multiple reinsurance treaties, to multiple reinsurance companies. Reinsurance agreements mitigate State Fund's liability on some individual claims, on some layers of loss, on some blocks of business and on catastrophic exposure. In accordance with statutory accounting practices, when permissible, the reinsured risks are treated for financial statement presentation purposes as though State Fund is not liable for reinsured losses. State Fund, however, has a contingent risk with respect to insurance ceded to the extent that reinsurers would be unable to meet the obligations assumed under reinsurance contracts.

In 2012, for all natural catastrophes, State Fund was covered by per occurrence excess of loss reinsurance for $250 million of losses in excess of $300 million for a catastrophe involving at least 20 claimants. The treaties provided for one reinstatement to the full original limit, for an additional premium calculated as a pro rata share of the original premium, based on the portion of each layer being reinstated.

State Fund was also covered in 2012 by a catastrophe bond issued by special purpose reinsurer that would provide up to $200 million of modeled earthquake losses from an occurrence expected to cause $100 million in losses in a notional portfolio matching that of State Fund: the Company's actual loss experience may differ from the notional modeled losses. The proceeds on the notes will be held in trust to collateralize the agreement with State Fund and in the event of claim, State Fund can draw on the collateral. This catastrophe bond has the potential to cover loss for earthquake with a magnitude greater than or equal to Mw 5.5 for the period from December 9, 2011 until December 31, 2014.

For terrorism incidents, including losses generated from nuclear, biological, chemical, or radiological events, State Fund was covered by a combination of private reinsurance and the Federal Risk Insurance Program Reauthorization Act of 2007 (TRIPRA). TRIPRA provided coverage for 85% of

losses in excess of 20% of 2011 Direct Earned Premium, or approximately $203 million. A private per occurrence excess of loss reinsurance treaty covered $100 million of losses in excess of $203 million not covered by TRIPRA, for an incident involving at least 14 claimants

In 2012, State Fund used the modeling resources of its lead reinsurance intermediary to estimate the cumulative exceedance probability curve for aggregate annual terrorism losses and for per occurrence earthquake losses at both random and peak exposure periods. Standard catastrophe models were used to determine the selected reinsurance structure based on State Fund's existing capital.

In 2011, for natural catastrophes, State Fund was covered by per occurrence excess of loss reinsurance treaties in two layers totaling $450 million of losses in excess of $300 million for a catastrophe involving at least 20 claimants. The treaties provided for one reinstatement to the full original limit, for an additional premium calculated as a pro rata share of the original premium, based on the portion of each layer being reinstated.

For terrorism incidents, including losses generated from nuclear, biological, chemical, or radiological events, State Fund was covered by a combination of private reinsurance and the TRIPRA. TRIPRA provided coverage for 85% of losses in excess of 20% of 2010 Direct Earned Premium, or approximately $230 million. A private per occurrence excess of loss reinsurance treaty covered $120 million of losses in excess of $230 million not covered by TRIPRA, for an incident involving at least 16 claimants. Since this treaty only covered the 15% not covered by TRIPRA, it amounted to a total of $800 million of coverage when combined with TRIPRA.

In 2011, State Fund used the modeling resources of its lead reinsurance intermediary to estimate the cumulative exceedance probability curve for aggregate annual terrorism losses and for per occurrence earthquake losses at both random and peak exposure periods. Standard catastrophe models were used to determine the selected reinsurance structure based on State Fund's existing capital.

(b) Commutation

For the year ended December 31, 2012, State Fund commuted reinsurance recoverable of $29,465 reflected as losses incurred and loss adjustment expenses incurred amounting to $29,352 and $113, respectively, from various reinsurers listed below:

		2012
LDG/Transatlantic Ins. Co.	$	4,302
Everest Reins Co.		22,339
AUL/UNUM Life Insurance Co.		870
Lincoln National Insurance Co		547
American United Life Insurance Co		1,407
Total	$	29,465

For the year ended December 31, 2011, State Fund commuted reinsurance recoverable of $29,826 reflected as losses incurred and Loss adjustment expenses incurred amounting to $29,733 and $93, respectively, from various reinsurers listed below:

		2011
John hancock Life Insurance Co.	$	4,890
Reliastar Life Insurance Co.		7,729
Canada Life Insurance Co.		4,891
American National Life Insurance Co.		1,915
Excalibur Reinsurance Co.		1,594
American United Life Insurance Co		8,807
Total	$	29,826

(c) Loss Portfolio Transfer (LPT)

In August 2002, State Fund entered into a Loss Portfolio Transfer agreement (LPT) with XL Re Ltd. and ACE Bermuda Insurance Ltd. (the Reinsurers). The retroactive reinsurance agreement reinsured losses paid after January 1, 2002 on accident years 1980 through 1998. Under the LPT, State Fund retains liability for the first $950,000 of aggregate subject losses. In the first reinsured layer of coverage, the Reinsurers are liable for a 90% share of the next $1,150,000 of subject losses. Upon exhaustion of the first layer, State Fund retains the next $200,000 of subject losses in excess of $2,100,000. Then in a second reinsured layer, the Reinsurers are liable for a 90% share of the next $300,000 of subject losses. The maximum amount recoverable from the Reinsurers under both reinsured layers of the treaty is 90% of $1,450,000.

Under the LPT, State Fund initially recorded a retroactive ceded loss reserves credit of $1,035,000 for a payment of $728,744, thus recognizing a retroactive gain of $319,756. The gain was recorded as special surplus for retroactive reinsurance. The special surplus arising from the transaction will be considered to be earned surplus and transferred to unassigned funds (surplus) when cash recoveries from the Reinsurers exceed the total consideration paid by State Fund for the LPT. Additionally, State Fund received $1,791 as interest on monies held by the Reinsurers prior to the final consummation of the LPT. This resulted in a net amount paid by State Fund of $726,953.

By December 31, 2005, State Fund's carried gross loss reserves for the subject losses exceeded the upper limit of the second layer of the treaty. State Fund increased retroactive ceded reserves by an additional $270,000 (the $300,000 in the second layer less State Fund's 10% retention). As a result, State Fund recognized an additional retroactive gain of $256,500 ($270,000 net of a $13,500 deposit with Reinsurers for the coverage). Special surplus for retroactive reinsurance increased from $319,800 in 2004 to $576,300 at year-end of 2005. The special surplus for retroactive reinsurance changed in 2012 as the recovered exceeded LPT consideration paid. The special surplus for retroactive reinsurance was reduced by $47,259 (i.e., transferred to unassigned surplus) in 2012 as the cash recoveries exceeded the LPT consideration paid.

Effective January 1, 2007, XL Re Ltd. assumed all the rights and obligations of Ace Bermuda Insurance Ltd. to State Fund under the LPT through an Assumption Reinsurance and Novation Agreement.

The original LPT contained a provision under the "Large Payment Oversight" clause, which was intended to address acceleration of payments due to settlement of claims. If the aggregate of Large Payments (defined as individual payments exceeding $10,000 intended to settle future liability) exceeds tabled values in the treaty (as specified at successive year-ends), this would void coverage on claims with subsequent Large Payments unless the Reinsurers provide prior written consent for the payments, or State Fund agreed that reimbursement would be apportioned over the life expectancy of the injured employee.

The Large Payment Oversight provision was triggered in the third quarter of 2009. In order to simplify administration by all parties of this provision, State Fund and the Reinsurer amended the original LPT contract to allow the deferral of subsequent Large Payments to be done on the aggregated total for each calendar quarter, based on an agreed average life expectancy for the entire body of claim involved in the LPT.

As of December 31, 2012 and 2011, cumulative subject paid losses were $1,934,863 and $1,819,982, respectively, which exceeded the $950,000 retention. These netted to total billed losses of $886,378 and $782,984 to the Reinsurers (after State Fund's 10% retention) as of December 31, 2012 and 2011, respectively, of which $776,003 and $707,959 were collected from the Reinsurers as of December 31, 2012 and 2011, respectively.

(9) Commitments and Contingencies

State Fund leases certain office space, furniture, equipment, and vehicles under noncancelable operating leases. The aggregate minimum annual lease payments under such operating leases as of December 31, 2012 were as follows:

Year:		
2013	$	22,640
2014		15,952
2015		6,755
2016		3,114
2017		2,964
Future years		11,345
Total	$	62,770

Leases for office space generally require additional payments comprising State Fund's pro rata share of increases in real estate taxes and building operating expenses. For the years ended December 31, 2012 and 2011, the total rental expense for office space was $50,031 and $57,419, respectively, which included an allocation of rental value to space owned and occupied by State Fund of $34,813 and $37,171,

respectively. Vehicle and other lease expenses were $5,304 and $15,325 for the years ended December 31, 2012 and 2011, respectively.

Lawsuits arise against State Fund in the normal course of business. Contingent liabilities arising from litigation and other matters are not considered material in relation to the financial position of State Fund.

(10) Pension and Other Postemployment Benefit Plans

State Fund incurred pension expense of $61,014 and $61,601 for the years ended December 31, 2012 and 2011, respectively.

State Fund paid retiree health benefit pro rata assessments of $44,438 and $36,921 for the years ended December 31, 2012 and 2011, respectively. The following table shows the components of State Fund's allocation of the State's 2012 and 2011 ARC, OPEB cost, the amount credited to the plan, and changes in the net OPEB obligation as of December 31, 2012 and 2011:

		2012	2011
Annual required contribution	$	145,562	119,191
Adjustment to annual required contribution		1,447	1,086
Annual OPEB cost		147,009	120,277
Estimated contribution credit		(46,726)	(35,339)
Increase in net OPEB obligation		100,283	84,938
Net OPEB obligation beginning of year		390,440	305,502
Net OPEB obligation end of year	$	490,723	390,440

The percentage of annual OPEB costs contributed to the plan was 32% for 2012 and 30% for 2011.

Based on the latest actuarial assessment of State's unfunded liabilities as of June 30, 2011, and the emergence pattern of State Fund's share in terms of payroll and headcount as a percentage of the State as of December 31, 2012, State Fund's estimated share of unfunded OPEB and pension is within the range of $1 – 2 billion and State Fund has recorded the midpoint of the range, or $1.5 billion, as our estimated unfunded amount.

Effective December 31, 2012, State Fund has established a segregated surplus account to provide for the portion of the contingency for OPEB and pension that has not already been accrued as a liability. As of December 31, 2012, the portion of the unfunded OPEB contingency that has already been allocated to State Fund and accrued as a liability is $490,723, and the remaining estimated contingency of $1,009,277 has been recorded as special surplus for unfunded pension and OPEB.

(11) Policyholders' Dividends

State Fund declared $100,000 in dividends in 2012. The qualifying policyholders will receive 10% of estimated annual premium for the 2012 policy year. State Fund declared $50,000 in dividends in 2011.

(12) Related Parties

State Fund has an agreement with the State of California Department of Personnel Administration to adjust the claims and process the payments related to those claims on behalf of state agencies. State Fund pays compensation benefits to the injured workers and medical benefits to the health providers. State Fund is reimbursed by the state agencies for compensation and medical benefits paid, and the cost of processing claims. State Fund records a receivable for these reimbursements under "Due from adjusting contracts." All agencies make deposits in a trust account that is held by State Fund for future bills. The deposits are reported under "Amounts held in trust liability."

(13) Special Surplus Funds

The following summarizes changes in the balances of special surplus funds for 2012. There were no changes in such balances in 2011.

		Retroactive reinsurance	Unfunded pension and OPEB
Balance at December 31, 2011	$	576,256	—
Transfer from recoveries under LPT		(47,259)	—
Establishment of fund for pension and OPEB contingency		—	1,009,277
Balance at December 31, 2012	$	528,997	1,009,277

(14) Subsequent Events

Management of State Fund has evaluated all events occurring after December 31, 2012 through May 10, 2013, the date the financial statements were available to be issued, to determine whether any event required either recognition or disclosure in the financial statements, noting no such event.

Schedule I

STATE COMPENSATION INSURANCE FUND

Supplemental Investment Risk Interrogatories

December 31, 2012

(Dollar amounts in thousands)

State Fund's total admitted assets as filed in the 2012 Annual Statement is: $ 19,434,118

State Fund's ten largest exposures to a single issuer/borrower/investment:

Issuer	Description of exposure	Amount	Percentage of total admitted assets
Goldman Sachs Group, Inc.	Industrial & Miscellaneous	$ 165,479	0.9%
JP Morgan Chase & Company	Industrial & Miscellaneous	162,858	0.8
Wells Fargo & Company	Industrial & Miscellaneous	162,157	0.8
General Elec Cap Corporation	Industrial & Miscellaneous	157,646	0.8
Praxair Inc.	Industrial & Miscellaneous	128,787	0.7
Duke Energy Corporation	Industrial & Miscellaneous	107,032	0.6
Southern California Public Power Authority PW	Special Revenue	106,956	0.6
Medtronic Inc.	Industrial & Miscellaneous	106,266	0.5
Occidental Petroleum Corporation	Industrial & Miscellaneous	106,000	0.5
The Coca Cola Company	Industrial & Miscellaneous	105,225	0.5

The amounts and percentages of State Fund's total admitted assets held in bonds by NAIC rating are as follows:

Ratings	Amount	Percentage of total admitted assets
NAIC – 1	$ 18,104,198	93.2%
NAIC – 2	128,655	0.7
NAIC – 3	—	—
NAIC – 4	—	—
NAIC – 5	—	—
NAIC – 6	—	—

State Fund does not have any preferred stocks.
State Fund does not hold any foreign investments.
State Fund's Canadian investments is less than 2.5% of the total admitted assets.
State Fund's real estate is less than 2.5% of the total admitted assets.

See accompanying independent auditors' report.

Schedule II

STATE COMPENSATION INSURANCE FUND

Supplemental Summary Investment Schedules

December 31, 2012

(Dollar amounts in thousands)

State Fund had the following invested assets as of December 31, 2012:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	**Percentage**	**Amount**	**Percentage**
Bonds:				
U.S. Treasury securities	$ 1,168,968	6.2%	$ 1,168,968	6.2%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	9,964	0.1	9,964	0.1
Issued by U.S. government-sponsored agencies	1,395,743	7.4	1,395,743	7.4
Non-U.S. government (including Canada, excluding mortgage-backed securities)	228,533	1.2	228,533	1.2
Securities issued by states, territories, and possessions, and political subdivisions in the United States:				
States, territories, and possessions general obligations	351,890	1.9	351,890	1.9
Political subdivisions of states, territories, and possessions and political subdivisions general obligations	291,978	1.5	291,978	1.5
Revenue and assessment obligations	1,828,842	9.6	1,828,842	9.6
Industrial development and similar obligations	29,295	—	29,295	—
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	740,372	3.9	740,372	3.9
Issued or guaranteed by FNMA and FHLMC	4,538,720	23.9	4,538,720	23.9
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	1,860,980	9.8	1,860,980	9.8
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	5,498,960	28.9	5,498,960	28.9
Unaffiliated non-U.S. securities (including Canada)	288,607	1.5	288,607	1.5
Real estate investments:				
Property occupied by company	337,389	1.8	337,389	1.8
Property held for sale	16,155	—	16,155	—
Receivable for securities	2,035	—	2,035	—
Cash, cash equivalents, and short-term investments	430,904	2.3	430,904	2.3
Total cash and investments	$ 19,019,335	100.0%	$ 19,019,335	100.0%

See accompanying independent auditors' report.

STATE COMPENSATION INSURANCE FUND

Reinsurance Interrogatory

December 31, 2012

The following disclosures are limited to reinsurance contracts entered into, renewed, or amended on or after January 1, 1994:

(1) State Fund has not reinsured any risk with any other entity under a quota share reinsurance contract.

(2) Except for the exception detailed below, State Fund has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

(a) A contract term longer than two years and the contract is noncancelable by State Fund during the contract term;

(b) A limited or conditional cancellation provision under which cancellation triggers an obligation by State Fund, or an affiliate of State Fund, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

(c) Aggregate stop-loss reinsurance coverage;

(d) An unconditional or unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions that are only triggered by a decline in the credit status of the other party;

(e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

(f) Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

Exception relative to (2)(f): State Fund has entered into an LPT treaty, which includes the following provision: If the aggregate paid Large Payments exceed values in a Cumulative Large Payment Loss Triggers Table, the State Fund will not affect any Large Payment exceeding $10,000 (but excepting those payments that State Fund is compelled to pay by operation of §5100 through §5106 of the California Labor Code), without obtaining the Reinsurer's prior written consent. If any claim paid by State Fund is inconsistent with the limitations set forth in this Article, reinsurance coverage provided pursuant to this Agreement for such claim will be void unless the Reinsurers consent, at their sole option, to provide coverage for such Large Payment, which consent will not be withheld if State Fund agrees that the obligation of the Reinsurers to pay State Fund for such Large Payment made by State Fund in settlement of such claim will be apportioned in equal amounts to each calendar year within the life expectancy of the injured employee who is the subject of the claim.

This provision was triggered as of the third quarter of 2009. For administrative convenience State Fund and the reinsurer have agreed that subsequent large loss payments will be recovered from the reinsurer pro rata over an agreed average life expectancy, using an agreed format. This change was formalized in an amendment to the original contract.

(3) State Fund has not, during the period covered by the statement, ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders, where:

(a) The written premium ceded to the reinsurer by State Fund or its affiliates represents fifty% (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to State Fund or its affiliates.

(4) State Fund has not ceded any risk under any reinsurance contract during the period covered by the financial statement, and either:

(a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or

(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

State Fund has filed the Reinsurance Attestation Supplement with the CDI and NAIC with no exception.

See accompanying independent auditors' report.