



**STATE COMPENSATION INSURANCE FUND**

Statutory Basis Financial Statements

December 31, 2013 and 2012

(With Independent Auditors' Report Thereon)



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

## **Independent Auditors' Report**

The Audit Committee of the Board of Directors  
State Compensation Insurance Fund:

### ***Report on the Financial Statements***

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, 2013 and 2012, 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, 2013 and 2012, 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, 2013 and 2012, 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 11 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 in the supplemental investment risk interrogatories (Schedule I), supplemental summary investment schedules (Schedule II), and supplemental reinsurance interrogatories (Schedule III) 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.

**KPMG LLP**

San Francisco, California  
May 22, 2014

## STATE COMPENSATION INSURANCE FUND

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

December 31, 2013 and 2012

(In thousands)

<b>Admitted Assets</b>	<b>2013</b>	<b>2012</b>
Bonds, at amortized cost	\$ 17,459,326	18,232,852
Common stocks	917,328	—
Real estate	319,241	353,544
Cash, cash equivalents, and short-term investments	155,161	430,904
Receivables for securities	191	2,035
Total cash and investments	18,851,247	19,019,335
Premiums in the course of collection	57,257	38,299
Earned but unbilled premiums	58,250	53,342
Reinsurance recoverables	1,934	3,122
Accrued interest and dividends	141,475	151,213
Guaranty fund receivables	49,789	73,453
Due from adjusting contracts	30,953	34,153
Other assets	38,120	61,201
Total admitted assets	\$ 19,229,025	19,434,118
<b>Liabilities and Policyholders' Surplus</b>		
Estimated liabilities for:		
Losses	\$ 10,502,660	11,193,897
Loss adjustment expenses	1,598,389	1,732,627
Retroactive reinsurance ceded	(504,999)	(528,997)
Unearned premiums	55,072	47,026
Dividends reserve	172,120	131,182
Other post employment benefit liability	540,509	490,723
Borrowed money and interest thereon	97,133	—
Deposit liability	117,307	101,298
Self-insurance reserve	105,904	113,535
Other liabilities	191,470	140,958
Total liabilities	12,875,565	13,422,249
Special surplus funds for:		
Retroactive reinsurance	504,999	528,997
Unfunded pension and other post employment benefits	957,413	1,009,277
Unassigned surplus	4,891,048	4,473,595
Policyholders' surplus	6,353,460	6,011,869
Total liabilities and policyholders' surplus	\$ 19,229,025	19,434,118

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, 2013 and 2012

(In thousands)

	<u>2013</u>	<u>2012</u>
Net premiums earned	\$ 1,093,782	922,635
Losses incurred	820,337	691,975
Loss adjustment expenses incurred	295,321	207,593
Underwriting and administrative expenses	<u>279,674</u>	<u>356,588</u>
Total underwriting deductions	<u>1,395,332</u>	<u>1,256,156</u>
Net underwriting loss	(301,550)	(333,521)
Net investment income earned	683,968	759,610
Net realized capital gains	3,867	42,821
Other loss	<u>(22,088)</u>	<u>(10,733)</u>
Net income before dividends to policyholders	364,197	458,177
Dividends to policyholders	<u>85,323</u>	<u>99,500</u>
Net income	278,874	358,677
Policyholders' surplus, beginning of year	6,011,869	5,662,692
Change in nonadmitted assets	16,412	(11,329)
Change in net unrealized capital gain	98,582	—
Unfunded actuarial accrued liability allocation	(51,864)	—
Change in provision for reinsurance	<u>(413)</u>	<u>1,829</u>
Policyholders' surplus, end of year	\$ <u><u>6,353,460</u></u>	<u><u>6,011,869</u></u>

See accompanying notes to statutory basis financial statements.

## STATE COMPENSATION INSURANCE FUND

### Statements of Cash Flow (Statutory Basis)

Years ended December 31, 2013 and 2012

(In thousands)

	2013	2012
Cash from operation:		
Premiums collected net of reinsurance	\$ 1,046,552	833,018
Net investment income	753,749	843,182
Other income received	12,316	25,308
Benefits and loss-related payments	(1,510,387)	(1,492,100)
Other underwriting expenses	(699,300)	(857,121)
Net cash used in operations	(397,070)	(647,713)
Cash from investments:		
Proceeds from investments sold, matured, or repaired:		
Bonds	3,896,970	4,862,996
Common stocks	44,670	—
Real estate	9,295	10,895
Change in receivable for securities	1,843	—
Cost of investments acquired:		
Bonds	(3,150,294)	(4,170,670)
Common stocks	(861,816)	—
Real estate	(5,689)	(14,180)
Change in payable for securities	23,503	(1,437)
Net cash (used in) provided by investments	(41,518)	687,604
Cash from financing and miscellaneous sources:		
Borrowed funds	97,133	—
Other cash provided	65,712	260,885
Net cash provided by financing and miscellaneous sources	162,845	260,885
Net change in cash, cash equivalents and short-term investments	(275,743)	300,776
Cash, cash equivalents and short-term investments, beginning of year	430,904	130,128
Cash, cash equivalents and short-term investments, end of year	\$ 155,161	430,904

See accompanying notes to statutory basis financial statements.

# STATE COMPENSATION INSURANCE FUND

## Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

### (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.

State Fund was organized pursuant to and operates in accordance with Sec. 11770 of the California Insurance Code. In accordance with the Code, the Board of Directors of State Fund is composed of eleven members, nine of whom shall be appointed by the Governor. The Speaker of the Assembly shall appoint one member who shall represent organized labor, and the Senate Committee on Rules shall appoint one member who shall have been a policyholder or an officer or employee of a policyholder of State Fund.

State Fund's objective is to serve all California employers as an efficient and fairly priced industry leader in worker's compensation insurance and to compete with other insurance companies. State Fund is self-supported with revenues from premiums written and from investment income. It does not receive any financial support from the State and the State 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. As a state official approves State Fund's governing board members, U.S. generally accepted accounting standards (GAAP) for the State Fund are those promulgated by the Governmental Accounting Standards Board (GASB) which are the accounting standards applicable to state and local governmental entities.

Statutory accounting practices differ in certain respects from GAAP, 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 fair value with changes in fair value reflected in net income.
- Unrealized gains and losses on investments in common stocks are credit or charged directly to policyholders' surplus, whereas under GASB such changes in fair value would be reflected in net income.
- 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

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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, other underwriting expenses, and investment expenses, whereas under GASB, these would be 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 would be excluded under GASB.
- The statement of cash flow 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.
- Statutory accounting allows a company to segregate surplus to provide for contingencies; while generally, GASB would not allow equity to be restricted unless required by law.

The effects on the financial statements of the variances noted above, although not reasonably determined, are presumed to be material.

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

The preparation of financial statements in conformity with statutory accounting principles prescribed or permitted 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

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(Dollar amounts in thousands)

postemployment benefits (OPEB) costs estimated by State Fund 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 (SVO) 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 constant yield 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. Common stocks are carried at fair value.

State Fund uses widely accepted cash flow models from third-party data providers, which use 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.

Fair value for bonds 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. Fair value for common stock is primarily determined using a pricing hierarchy from a widely accepted pricing vendor.

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 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

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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.

Realized capital gains or losses on bonds are recognized on a specific identification basis when securities are sold, redeemed or otherwise disposed and reported as realized gains/losses in the statement of operations. Unrealized gains and losses for assets carried at fair value are reflected in policyholders' surplus.

For bonds, interest income for any period consist of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. Investment income is reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees are reported as investment income when received.

Dividends on common stock are recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income is recorded on stocks declared to be ex-dividends on or prior to the statement date).

(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. Real estate held for sale is measured at fair value on a non-recurring basis due to the impairments recognized as of December 31, 2013 and 2012. The fair value is obtained from third-party and/or internal appraisals less estimated costs to sell. Depreciation on buildings is computed on a straight-line basis over the estimated useful lives of the buildings (50 years). Impairment loss is measured as the amount by which the individual carrying amounts exceed the fair value of properties occupied or properties held for production.

Data processing equipment, telephone 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.

Consistent with Statement of Statutory Accounting Principles (SSAP) No. 16R, *Electronic Data Processing Equipment and Accounting Software*, State Fund has a written capitalization policy for

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purchases of items such as electronic data processing equipment, vehicles, furniture, fixture, equipment and leasehold improvements. The predefined capitalization thresholds under this policy have not changed during 2013 and 2012 except those for internally developed software. The capitalization threshold for internally developed software was changed during 2013 to \$15 million from \$500 thousand. The reason for increasing the threshold is to capitalize only those that require significant investment.

**(f) *Losses and Loss Adjustment Expenses***

Management records its best estimate of the liabilities for losses and loss adjustment expenses (LAE). 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 8).

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 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. Subrogation recoveries are considered when setting loss reserves. The estimated subrogation included as a reduction to IBNR was \$32,008 and \$29,536 as of December 31, 2013 and 2012, respectively.

**(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.

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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. State Fund reflects 10% of EBUB in excess of collateral specifically held and identifiable on a per policy basis as a nonadmitted asset. To the extent that amounts in excess of the 10% of EBUB are not anticipated to be collected, they are written off against operations in the period that the determination is made.

State Fund previously estimated accrued retrospective premiums through the review of each individual retrospectively rated risk, comparing case basis loss development with that anticipated in the policy contract to arrive at the best estimate of return or additional retrospective premium, subject to 10% nonadmittance rules as prescribed by SSAP No. 66, *Retrospectively Rated Contracts*. As of December 31, 2013 and 2012, there were no accrued retrospective premiums. Therefore, there were no nonadmitted amounts.

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 unearned premium. As of December 31, 2013 and 2012, 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*

In the normal course of business, State Fund purchases reinsurance to limit its net exposure to catastrophic and other events.

State Fund evaluates and monitors the financial condition of its reinsurers under reinsurance arrangements to minimize its exposure to significant losses from reinsurer insolvencies. State Fund does not believe it is exposed to any material credit risk.

State Fund analyzes its reinsurance agreements to ensure that they meet risk transfer requirements. The reinsurer must assume significant insurance risk under the reinsured portions of the underlying insurance contracts and there must be a reasonably possible chance that the reinsurer may realize a significant loss from the transaction. Based on management's evaluation, the reinsurance agreements transfer significant insurance risk and, accordingly, are accounted for as reinsurance.

Reinsurance recoverables on paid losses and 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

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Industrial Relations (DIR) to protect claimants against insurer insolvencies and administer various aspects of the workers' compensation system. The 2013 and 2012 annual CIGA assessment was 2% and 2.285%, respectively, of direct written premium. The DIR assessment aggregates to approximately 2.83% and 1.96% of direct written premium for 2013 and 2012, 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. CIGA surcharges related to unexpired policies and DIR surcharges collected in excess of 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 2.25% 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 \$8,650 and \$9,268 included in the "other liabilities" account as of December 31, 2013 and 2012, 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. As a result, State Fund recognizes pension and OPEB expense equal to its allocation from the State of the pension and OPEB cost for the period.

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

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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.

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* (GASB 45). The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year (Normal Cost) and amortize any unfunded actuarial liabilities (or funding excess) (UAAL) 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 estimated by State Fund, and will change over time.

Based on information provided to State Fund by the State of California, in the June 30, 2013 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 4.25%, and an annual healthcare cost trend rate of 8.5% in 2015 graded down over six 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 2013.

Effective December 31, 2012, State Fund 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 (Unfunded Actuarial Accrued Liability – "UAAL"), as permitted by SSAP No. 72, *Surplus and*

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*Quasi-Reorganizations.* It is uncertain when the State Controller's Office (SCO) will assess State Fund for the entire UAAL which could also vary significantly when actually assessed by SCO due to various key assumptions such as: State Fund's ultimate allocated share of the liability, discount rate used to develop the present value of future benefits, healthcare inflation, projected healthcare claims, and the likelihood an employee retires, elects healthcare coverage, and survives after retirement and the effect of market conditions on plan assets. State Fund updates their estimate each year-end.

Based on discussions with the CDI, beginning in 2013, State Fund recognizes in the statement of operations only the annual Normal Cost allocation from the State, as this is the Company's current year expense for the plan for the period, in accordance with statutory accounting for plans in which an insurer participates but is not directly liable. The annual UAAL allocation from the State is recorded a direct reduction to surplus.

**(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) *Reclassification***

Certain amounts in prior year financial statement balances and footnote disclosures have been reclassified to conform to the current year 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, 2013 and 2012, policyholders' surplus exceeded the minimum RBC requirements.

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**(4) Investment Securities**

State Fund's investment comprise of bonds and common stocks.

**(a) Bonds**

The carrying value and fair value of investments in bonds as of December 31, 2013 and 2012 are as follows:

<b>2013</b>				
	<b>Carrying value</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>
All other governments	\$ 213,780	15,768	(419)	229,129
Industrial and miscellaneous	6,376,500	224,652	(140,654)	6,460,498
Political subdivisions	272,670	18,882	(3,774)	287,778
Special revenue/assessment	3,161,275	157,480	(36,077)	3,282,678
States territories and possessions	302,326	21,027	(903)	322,450
U.S. government	951,198	72,686	(4,817)	1,019,067
Mortgage backed securities:				
Special revenue/assessment	5,012,320	134,605	(106,229)	5,040,696
U.S. government	1,169,257	50,552	(24,240)	1,195,569
Totals	\$ <u>17,459,326</u>	<u>695,652</u>	<u>(317,113)</u>	<u>17,837,865</u>
<b>2012</b>				
	<b>Carrying value</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>
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/assessment	3,246,678	372,057	(573)	3,618,162
States territories and possessions	351,890	56,244	—	408,134
U.S. government	1,178,932	117,672	—	1,296,604
Mortgage backed securities:				
Special revenue/assessment	5,350,595	306,618	(930)	5,656,283
U.S. government	1,806,084	167,778	(80)	1,973,782
Totals	\$ <u>18,232,852</u>	<u>1,554,653</u>	<u>(4,145)</u>	<u>19,783,360</u>

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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 considering the amount of the impairment relative to book value, factors including credit quality, market analysis, current events, management's intent and ability to hold the investment to recovery of the unrealized loss, underlying collateral and management's judgment are used to determine whether securities are considered other than temporarily impaired. As of December 31, 2013 and 2012, 683 and 60 securities were in an unrealized loss position, which resulted in an unrealized loss of \$317,113 and \$4,145, respectively. As of December 31, 2013, the unrealized loss position was attributed to the increase in interest rates over the course of 2013. This led to a downward price movement across all sectors in the bond portfolio, given the inverse relationship between interest rates and bond fair values. State Fund's bond portfolio is primarily comprised of investment grade securities. As of December 31, 2013, 98% of all bonds held by State Fund were rated Class 1 by the NAIC. State Fund concluded that the gross unrealized losses of \$317,113 as of December 31, 2013 were temporary in nature.

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2013 and 2012:

	<b>2013</b>					
	<b>12 Months or under</b>		<b>Over 12 months</b>		<b>Total</b>	
	<b>Fair value</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>	<b>Gross unrealized losses</b>
All Other Governments	\$ 29,552	(419)	—	—	29,552	(419)
Industrial and miscellaneous	2,622,730	(133,320)	80,990	(7,334)	2,703,720	(140,654)
Political Subdivision	61,729	(3,774)	—	—	61,729	(3,774)
Special revenue/assessment	613,971	(36,077)	—	—	613,971	(36,077)
States Territories and Possessions	21,881	(903)	—	—	21,881	(903)
U.S. government	83,321	(4,817)	—	—	83,321	(4,817)
Mortgage backed securities:						
U.S. government	307,159	(24,240)	—	—	307,159	(24,240)
Special revenue/assessment	2,324,488	(91,577)	154,767	(14,652)	2,479,255	(106,229)
<b>Totals</b>	<b>\$ 6,064,831</b>	<b>(295,127)</b>	<b>235,757</b>	<b>(21,986)</b>	<b>6,300,588</b>	<b>(317,113)</b>

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	<b>2012</b>					
	<b>12 Months or under</b>		<b>Over 12 months</b>		<b>Total</b>	
	<b>Fair value</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>	<b>Gross unrealized losses</b>
Industrial and miscellaneous	\$ 287,800	(2,562)	—	—	287,800	(2,562)
Special revenue/assessment	42,594	(326)	4,380	(247)	46,974	(573)
Mortgage backed securities:						
Special revenue/assessment	304,973	(930)	—	—	304,973	(930)
U.S. government	15,640	(80)	—	—	15,640	(80)
Totals	\$ 651,007	(3,898)	4,380	(247)	655,387	(4,145)

The carrying value and fair value of bonds as of December 31, 2013, 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. MBS provide for periodic payments through their lives so they are listed separately.

	<b>2013</b>	
	<b>Carrying value</b>	<b>Fair value</b>
Due in one year or less	\$ 820,554	835,340
Due after one year through five years	4,351,980	4,629,007
Due after five years through ten years	3,984,631	3,984,198
Due after ten years	2,120,585	2,153,056
Sum of amounts due from < 1 to >10 years	11,277,750	11,601,601
Mortgage-backed securities	6,181,576	6,236,264
Totals	\$ 17,459,326	17,837,865

Proceeds from sales of investments in bonds during 2013 were \$605,341 with gross realized gains of \$26,185 and gross realized losses of \$2,730.

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.

State Fund recognized no other-than-temporary impairment in bonds for the years ended December 31, 2013 and 2012.

State Fund had \$66,973 and \$67,061 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, 2013 and 2012, respectively.

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**(b) Common Stocks**

In 2013, State Fund started investing in common stocks as a result of the passage of California Senate Bill (SB) 1513, which expanded State Fund’s investment authority. The table below reflects cost, unrealized gains and losses, and fair value of investments in common stocks as of December 31, 2013.

	<b>2013</b>			
	<b>Cost</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>
Industrial and miscellaneous	\$ 818,745	101,636	(3,053)	917,328
Total common stocks	<u>\$ 818,745</u>	<u>101,636</u>	<u>(3,053)</u>	<u>917,328</u>

The table below reflects the summary of temporarily impaired common stocks as of December 31, 2013.

	<b>2013</b>					
	<b>Less than 12 months</b>		<b>12 months or more</b>		<b>Total</b>	
	<b>Fair value</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>	<b>Gross unrealized losses</b>
Industrial and miscellaneous	\$ 57,732	(3,053)	—	—	57,732	(3,053)
Total common stocks	<u>\$ 57,732</u>	<u>(3,053)</u>	<u>—</u>	<u>—</u>	<u>57,732</u>	<u>(3,053)</u>

Proceeds from sales of common stocks during 2013 were \$44,670 with gross realized gains of \$2,326 and gross realized losses of \$727.

State Fund recognized no other-than-temporary impairment in common stocks for the year ended December 31, 2013.

Effective April 1, 2013, State Fund became a member of the Federal Home Loan Bank (FHLB) of San Francisco. Pursuant to Insurance Code Section 11797(a) State Fund is authorized to join the FHLB and enter into loans with the FHLB and pledge securities as collateral for loans and advances. The FHLB Program was approved by the Board of Directors on February 13, 2013. Federal Home Loan Bank (FHLB) shares are valued at cost and not publicly traded. State Fund purchased \$25,000 FHLB common stock initial requirement to become a member of the FHLB of San Francisco.

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(c) **Structured securities and other**

State Fund does not engage in subprime residential mortgage lending nor does it invest directly in subprime fixed income securities. As of December 31, 2013 and 2012, State Fund has no direct subprime mortgage-related risk exposure. However, State Fund does invest primarily in 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, 2013 and 2012 were \$28,057 and \$16,694 respectively.

Net investment income earned by investment category for the years ended December 31, is as follows:

	<u>2013</u>	<u>2012</u>
Bonds	\$ 690,771	780,298
Common Stocks	10,766	—
Real Estate	30,593	39,312
Other	99	625
	<u>732,229</u>	<u>820,235</u>
Total investment income	732,229	820,235
Less investment expenses	<u>(48,261)</u>	<u>(60,625)</u>
Net investment income	<u>\$ 683,968</u>	<u>759,610</u>

(5) **Fair Value Measurement**

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.

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The table below summarizes State Fund's aggregate fair value of financial instruments by level 1, 2 and 3.

<b>December 31, 2013</b>						
	<b>Aggregate Fair value</b>	<b>Admitted assets</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Not practical carrying value</b>
Financial assets:	\$					
Bonds	17,837,865	17,459,326	—	17,827,663	10,202	—
Common stock	917,328	917,328	892,328	25,000	—	—
Cash	155,161	155,161	155,161	—	—	—
Receivables for securities	192	192	192	—	—	—
Financial liabilities:						
Borrowings	97,133	97,133	—	97,133	—	—
Payables for securities	23,503	23,503	23,503	—	—	—
<b>Totals</b>	\$ <b>19,031,182</b>	<b>18,652,643</b>	<b>1,071,184</b>	<b>17,949,796</b>	<b>10,202</b>	<b>—</b>

  

<b>December 31, 2012</b>						
	<b>Aggregate Fair value</b>	<b>Admitted assets</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Not practical carrying value</b>
Financial assets:	\$					
Bonds	19,783,360	18,232,852	—	19,776,307	7,053	—
Common stock	—	—	—	—	—	—
Cash	430,904	430,904	430,904	—	—	—
Receivables for securities	2,035	2,035	2,035	—	—	—
Financial liabilities:						
Borrowings	—	—	—	—	—	—
Payables for securities	—	—	—	—	—	—
<b>Totals</b>	\$ <b>20,216,299</b>	<b>18,665,791</b>	<b>432,939</b>	<b>19,776,307</b>	<b>7,053</b>	<b>—</b>

**(6) Borrowing**

State Fund is a member of the Federal Home Loan Bank (FHLB) of San Francisco. Through its membership, the State Fund has pledged to the FHLB bonds amounting to \$818,803 in exchange for cash advances with a current borrowing capacity of \$711,770. It is part of the State Fund strategy to utilize these funds for operations and investment in medium-term bonds. The total amount borrowed was \$97,133 as of year-end.

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The table below summarizes the date issued, maturity date, face value, interest rate and effective interest rate, and interest paid.

<b>December 31, 2013</b>					
<b>Date issued</b>	<b>Maturity date</b>	<b>Face value</b>	<b>Interest rate</b>	<b>Effective interest rate</b>	<b>Interest paid</b>
04/10/13	01/22/16	25,000	0.536%	0.536%	73
04/16/13	01/22/16	22,800	0.507%	0.507%	61
05/29/13	05/22/18	39,500	1.285%	1.285%	250
06/04/13	05/22/18	9,713	1.335%	1.335%	62
Totals		<u>97,013</u>			<u>446</u>

**(7) Real Estate, Furniture, and Equipment**

Real estate as of December 31, 2013 and 2012 comprises the following:

	<u><b>2013</b></u>	<u><b>2012</b></u>
Property occupied by the company	\$ 312,117	410,426
Property held for sale	90,277	32,172
	<u>402,394</u>	<u>442,598</u>
Accumulated depreciation	<u>(83,153)</u>	<u>(89,054)</u>
Totals	<u>\$ 319,241</u>	<u>353,544</u>

Depreciation expense on real estate was \$7,062 and \$10,226 for the years ended December 31, 2013 and 2012, respectively. Certain real estate properties owned were sold and impaired due to significant decrease in appraised value and intent to sell. State Fund realized a capital gain of \$952 and \$1,161 on sale of real estate properties as of December 2013 and 2012 respectively. As of December 2013 and 2012, State Fund impaired real estate properties held for sale, which resulted in a loss of \$24,588 and \$866, respectively, recorded as part of the net realized capital gain (loss).

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Furniture and equipment as of December 31, 2013 and 2012 comprise the following:

	<u>2013</u>	<u>2012</u>
Data processing equipment and software	\$ 300,737	291,766
Office furniture and equipment	49,925	52,202
	<u>350,662</u>	<u>343,968</u>
Accumulated depreciation	<u>(317,555)</u>	<u>(300,275)</u>
	33,107	43,693
Nonadmitted assets	<u>(23,915)</u>	<u>(39,025)</u>
Totals	\$ <u>9,192</u>	<u>4,668</u>

Depreciation expense on furniture and equipment was \$16,466 and \$18,580 for the years ended December 31, 2013 and 2012, respectively.

**(8) 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, 2013 and 2012. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of a loss portfolio transfer.

	<u>2013</u>	<u>2012</u>
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of \$142,466 and \$170,524, respectively	\$ 12,926,524	14,032,646
Add incurred related to:		
Current year	1,132,303	883,820
Prior years	<u>(16,644)</u>	<u>15,748</u>
Total incurred	<u>1,115,659</u>	<u>899,568</u>
Less paid related to:		
Current year	98,555	73,396
Prior years	<u>1,842,579</u>	<u>1,932,294</u>
Total paid	<u>1,941,134</u>	<u>2,005,690</u>
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of \$100,594 and \$142,466, respectively	\$ <u>12,101,049</u>	<u>12,926,524</u>

Incurred losses and loss adjustment expenses relating to insured events in prior years were approximately \$(16,644) and \$15,748 in 2013 and 2012, respectively. The favorable 2013 incurred related to prior years

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is immaterial and primarily attributable to an increase in the closing rate driven by an increased focus on compromise and release settlement agreements. The unfavorable 2012 incurred related to prior years is immaterial and primarily attributable to the strengthening of loss adjustment expense reserves and Medicare set aside requirements.

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 requirements, medical inflation, and changes in the utilization of medical procedures.

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 – 2012 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.

State Fund implemented tiered pricing in 2013 to differentiate the pricing of risks ranging from those written in competition with the private market to those which have greater loss potential and for whom State Fund acts as an insurer of last resort. Due to the limited experience under the new pricing system, there is increased pricing risk in the estimation of losses on policies written in 2013. One benefit may be greater diversification of the book of business as new business with a better loss profile is attracted through the new pricing structure. Over time this risk should diminish as the pricing tier structure matures. As of December 31, 2013, a small percentage of the total loss reserve arises from policies written since tiered pricing was introduced.

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 (SB 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. The full impact of SB 863 on incurred and unpaid claims is uncertain. In March 2010, the Affordable Care Act of 2010 (Affordable Care Act), was signed into law. The Affordable Care Act may impact healthcare costs and delivery. Since healthcare is the largest component of State Fund's loss costs, this legislation may impact State Fund, although the impact, if any, is uncertain.

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.

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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.

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:

	<u>2013</u>	<u>2012</u>
(1) Asbestos, direct:		
a. Beginning reserves (including case, bulk and IBNR, and LAE)	\$ 55,220	56,643
b. Losses and LAE incurred	(2,081)	3,984
c. Calendar year payments for losses and LAE	<u>(5,072)</u>	<u>(5,407)</u>
d. Ending reserves (including case, bulk and IBNR, and LAE)	\$ <u>48,067</u>	<u>55,220</u>
(2) Asbestos, assumed	\$ —	—
(3) Asbestos, net:		
a. Beginning reserves (including case, bulk and IBNR, and LAE)	\$ 51,330	54,013
b. Incurred losses and loss adjustment expenses	(749)	2,724
c. Calendar year payments for losses and LAE	<u>(6,514)</u>	<u>(5,407)</u>
d. Ending reserves (including case, bulk and IBNR, and LAE)	\$ <u>44,067</u>	<u>51,330</u>

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 aggregate amount (present value) of annuities due from life insurers under which the claimant is payee but for which State Fund is contingently liable was \$821,751 at December 31, 2013. State Fund has not purchased annuities from life insurers under which State Fund is the payee, and, therefore, no balances are due from such annuity insurers. During the years ended, December 31, 2013 and 2012, the direct reserve for losses and loss adjustment expenses was reduced by \$116,425 and \$117,191 respectively, through the purchase of such annuities. The total amount of loss reserves no longer carried due to the purchase of annuities, with the claimant as payee, was \$821,751 and \$726,259 as of December 31, 2013 and 2012, respectively. State Fund remains liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities.

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#### (9) Reinsurance

Certain premiums and losses are ceded to other insurance companies under various reinsurance agreements. These agreements are used by State Fund to manage exposure to loss. For the year ended December 31, 2013 and 2012, State Fund has reported ceded reinsurance balances (prior to the Loss Portfolio Transfer – “LPT” see Note 9(c) for disclosure on LPT,) as follows:

	<u>2013</u>	<u>2012</u>
Reinsurance premium ceded:		
Premium written	\$ 16,243	16,161
Premium earned	16,243	16,161
Premium payable	821	(769)
Loss and loss adjustment expense incurred	(6,243)	(9,114)
Loss and loss adjustment expense reserve	101,570	144,307

Ceded loss and loss adjustment expense reserves include \$24,416 and \$45,454 recoverable from Munich Reinsurance America, Inc. (Munich Re) and Reliastar Life Insurance Company (Reliastar) as of December 31, 2013, and \$68,006 and \$44,915 recoverable from Munich Re and Reliastar as of December 31, 2012. State Fund remains liable for amounts ceded in the event that reinsurers are unable to honor their obligations.

State Fund does not have an unsecured aggregate recoverable for losses, paid and unpaid, loss adjustment expenses and unearned premium with any individual reinsurers (excluding the LPT, see Note 9(c) for disclosure on LPT), authorized or unauthorized, that exceeds 3% of its policyholders’ surplus.

#### (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 uses 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.

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 reflected net of the related loss and loss adjustment expense reserves. State Fund,

## STATE COMPENSATION INSURANCE FUND

### Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

however, is responsible for the insurance ceded to the extent that reinsurers would be unable to meet the obligations assumed under reinsurance contracts.

In 2013 and 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 2013 and 2012 by a multi-year catastrophe bond issued by special purpose reinsurer that would provide up to \$200 million of modeled earthquake loss coverage from an occurrence expected to cause in excess of \$100 million in losses in a notional portfolio matching that of State Fund: the actual loss experience may differ from the notional modeled losses. Actual reimbursements under the catastrophe bond are ultimately adjusted to the lesser of a contractually defined commutation value based on expected ultimate losses and loss adjustment expenses or the 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 losses for earthquakes 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 in 2013, 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 2012 Direct Earned Premium, or approximately \$188 million. A private per occurrence excess of loss reinsurance treaty covered \$80 million of losses in excess of \$188 million not covered by TRIPRA, for an incident involving at least 13 claimants. Since this treaty only covered the 15% not covered by TRIPRA, it amounted to a total of approximately \$533 million of coverage when combined with TRIPRA.

For terrorism incidents in 2012, 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 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. 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.

**STATE COMPENSATION INSURANCE FUND**

Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

**(b) Commutation**

For the year ended December 31, 2013, State Fund commuted reinsurance recoverable of \$33,972 which included \$33,688 of losses incurred and \$284 of loss adjustment expenses, from the reinsurers listed below:

	<b>2013</b>
Munich Re	\$ 33,962
Colisee ( Formerly AXA Re)	10
Total	\$ 33,972

For the year ended December 31, 2012, State Fund commuted reinsurance recoverable of \$29,465 which included \$29,352 of losses incurred and \$113 of loss adjustment expenses incurred, from the reinsurers listed below:

	<b>2012</b>
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

**(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.

## STATE COMPENSATION INSURANCE FUND

### Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

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 began to decline in 2012 as the total recovered balance exceeded LPT consideration paid. The special surplus for retroactive reinsurance was reduced by \$23,997 in 2013 and \$47,259 in 2012 and transferred to unassigned surplus.

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, 2013, cumulative subject paid losses were \$2,046,506 which, after the \$950,000 retention, netted to total billed losses of \$986,855, of which \$800,000 was collected from the Reinsurers and \$116,613 was receivable but not yet due from deferred large loss settlements. As of December 31, 2012, cumulative subject paid losses were \$1,934,863, which, after the \$950,000 retention, netted to total billed losses of \$886,378, of which \$776,003 was collected from the Reinsurer and \$86,377 was receivable but not yet due from deferred large loss settlements.

As a result of a dispute arising in late 2012, as of December 31, 2013, an additional approximately \$60,000 in billed losses remained unpaid, for which Arbitration proceedings are ongoing regarding the timing of inclusion of certain claims for recovery under this contract. State Fund believes the amount of total recoveries under this contract is not in question; however, the timing of the payments that are to be included in current billings to XL Re Ltd is being debated. The outcome of these proceedings cannot be predicted at this stage.

## STATE COMPENSATION INSURANCE FUND

Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

### (10) 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, 2013 were as follows:

Year:		
2014	\$	11,660
2015		10,231
2016		9,569
2017		8,570
2018		7,362
Future years		<u>28,190</u>
Total	\$	<u><u>75,582</u></u>

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, 2013 and 2012, the total rental expense for office space was \$37,426 and \$50,031, respectively, which included an allocation of rental value to space owned and occupied by State Fund of \$26,032 and \$34,813, respectively. Vehicle and other lease expenses were \$9,889 and \$5,304 for the years ended December 31, 2013 and 2012, 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.

### (11) Pension and Other Postemployment Benefit Plans

State Fund incurred pension expense of \$54,850 and \$61,014 for the years ended December 31, 2013 and 2012, respectively.

**STATE COMPENSATION INSURANCE FUND**

Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

State Fund paid retiree health benefit pro rata assessments of \$40,040 and \$44,438 for the years ended December 31, 2013 and 2012, respectively. The following table shows the components of State Fund's allocation of the State's 2013 and 2012 Annual Required Contribution (ARC), OPEB cost, the amount credited to the plan, and changes in the net OPEB obligation as of December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Annual required contribution	\$ 93,386	145,562
Adjustment to annual required contribution	1,588	1,447
Annual OPEB cost	94,974	147,009
Estimated contribution credit	<u>(45,188)</u>	<u>(46,726)</u>
Increase in net OPEB obligation	49,786	100,283
Net OPEB obligation beginning of year	<u>490,723</u>	<u>390,440</u>
Net OPEB obligation end of year	<u>\$ 540,509</u>	<u>490,723</u>

The percentage of annual OPEB costs contributed to the plan was 48% for 2013 and 32% for 2012.

Based on the latest actuarial assessment of State's unfunded liabilities as of June 30, 2013, 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, 2013, 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.

As discussed in Note 2, State Fund 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, 2013 and 2012, the portion of the unfunded OPEB contingency that has already been allocated to State Fund and accrued as a liability is \$540,509 and \$490,723, respectively. Therefore, as of December 31, 2013 and 2012, the special surplus for unfunded pension and OPEB is \$957,413 and \$1,009,277, respectively.

State Fund's annual OPEB cost is based on the annual required contribution (ARC) as determined by the State of California, which comprises normal cost and amortization of the unfunded actuarial liabilities from prior years ("catch-up adjustments"), as required by GASB. State Fund estimates the ARC as of December 31 of each calendar year based on the latest available Actuarial Valuation Report, which is as of June 30 of the same calendar year, and its share of the State's OPEB cost. State Fund recognizes the normal cost as expense in the Statements of Operations and Policyholders' Surplus, and reduces the special surplus account for the amortization of the catch-up adjustment based on the allocation ratio between normal cost and UAAL. In 2013, State Fund recorded OPEB expenses of \$37,962 and reduced special surplus by \$51,864.

## STATE COMPENSATION INSURANCE FUND

Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

### (12) Policyholders' Dividends

State Fund declared \$100,000 in dividends for both years 2013 and 2012. The qualifying policyholders will receive 8.6% and 10%, respectively, of estimated annual premium for the 2013 and 2012 policy years.

### (13) Risks and Uncertainties

Some of State Fund's more significant risks are discussed below and in other notes to these financial statements. State Fund's business may also be adversely affected by risks and uncertainties not currently known or that are currently considered immaterial.

Many businesses in California are still experiencing a slow recovery from the severe economic recession. Though optimism is growing, economists and analysts expect that the recovery will remain modest and uneven in 2014. The Company is unable to predict the duration and severity of current economic conditions and their impact on California. Depressed economic conditions or sustained high levels of unemployment in California may negatively impact State Fund. A substantial amount of the State Fund's assets are invested in debt and equity securities. Defaults, downgrades, or other events impairing the value of securities owned may reduce policyholders' surplus.

State Fund invests in various investment securities which are exposed to various risks, such as interest rate, market risk and credit risk. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in values of investment securities will occur in the near term and that change could materially affect the amounts reported in the statutory basis financial statements. State Fund attempts to mitigate these risks by adhering to investment policies that provide portfolio diversification and by complying with investment limitations governed by state insurance laws and regulations, as applicable. Additionally, management actively manages the investment risks by monitoring credit and rating changes on its portfolio.

Underwriting risk is the risk that premiums from insured policies will be insufficient to cover the claims and expenses under the policies. State Fund's underwriting risk exposure is concentrated in California. As such, State Fund is exposed to losses from earthquakes, terrorist acts, and other catastrophic events, as well as the negative effects of significant economic and political events concentrated within the State. State Fund attempts to manage underwriting risk through price monitoring, which includes analyzing and monitoring current and historical State Fund data and industry data and trends, and through reinsurance.

Refer to Note 8 for discussion of the risks and uncertainties regarding estimates of reserves for losses and loss adjustment expenses incurred but unpaid.

### (14) Related Parties

State Fund has an agreement with the State of California Department of Human Resources 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

**STATE COMPENSATION INSURANCE FUND**

Notes to Statutory Basis Financial Statements

December 31, 2013 and 2012

(Dollar amounts in thousands)

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 included under “Other liabilities.”

**(15) Special Surplus Funds**

The following summarizes changes in the balances of special surplus funds for 2013:

	<b>Retroactive reinsurance</b>	<b>Unfunded pension and OPEB</b>
	<hr/>	<hr/>
Balance at December 31, 2012	\$ 528,997	1,009,277
Transfer from recoveries under LPT	(23,997)	—
Transfer to OPEB liability	—	(51,864)
	<hr/>	<hr/>
Balance at December 31, 2013	\$ 505,000	957,413
	<hr/> <hr/>	<hr/> <hr/>

The following summarizes changes in the balances of special surplus funds for 2012:

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

**(16) Subsequent Events**

Management of State Fund has evaluated all events occurring after December 31, 2013 through May 22, 2014, the date the financial statements were available to be issued, to determine whether any events required either recognition or disclosure in the financial statements, noting no such events other than items already disclosed in the financial statements.

**(17) Other Matters**

The CDI is currently conducting their triennial financial examination of State Fund for the years ended December 31, 2010, 2011 and 2012. A draft report, in final form, has been received and based on information in the report and communications with the CDI, management does not believe any findings have a material impact on State Fund’s financial condition or results of operations.

## STATE COMPENSATION INSURANCE FUND

## Supplemental Investment Risk Interrogatories

December 31, 2013

(Dollar amounts in thousands)

State Fund's total admitted assets as filed in the 2013 Annual Statement is: \$ 19,229,025  
 State Fund's ten largest exposures to a single issuer/borrower/investment:

<u>Issuer</u>	<u>Description of exposure</u>	<u>Amount</u>	<u>Percentage of total admitted assets</u>
JP Morgan Chase & Company	Industrial & Miscellaneous	\$ 218,733	1.1%
Wells Fargo & Company	Industrial & Miscellaneous	175,792	0.9
Goldman Sachs Group, Inc.	Industrial & Miscellaneous	174,202	0.9
Occidental Petroleum Corporation	Industrial & Miscellaneous	147,172	0.8
General Elec Cap Corporation	Industrial & Miscellaneous	143,321	0.7
Medtronic Inc.	Industrial & Miscellaneous	139,583	0.7
United Technologies Corporation	Industrial & Miscellaneous	138,669	0.7
Duke Energy Corporation	Industrial & Miscellaneous	128,579	0.7
Berkshire Hathaway Inc	Industrial & Miscellaneous	127,057	0.7
The Coca Cola Company	Industrial & Miscellaneous	124,421	0.6

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

<u>Ratings</u>	<u>Amount</u>	<u>Percentage of total admitted assets</u>
NAIC – 1	\$ 17,209,109	89.5%
NAIC – 2	250,217	1.3
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 equal to 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.

## STATE COMPENSATION INSURANCE FUND

## Supplemental Summary Investment Schedules

December 31, 2013

(Dollar amounts in thousands)

State Fund had the following invested assets as of December 31, 2013:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Bonds:				
U.S. Treasury securities	\$ 941,232	5.0%	\$ 941,232	5.0%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	9,967	0.1	9,967	0.1
Issued by U.S. government-sponsored agencies	1,234,583	6.5	1,234,583	6.5
Non-U.S. government (including Canada, excluding mortgage-backed securities)	213,780	1.1	213,780	1.1
Securities issued by states, territories, and possessions, and political subdivisions in the United States:				
States, territories, and possessions general obligations	302,326	1.6	302,326	1.6
Political subdivisions of states, territories, and possessions and political subdivisions general obligations	272,670	1.4	272,670	1.4
Revenue and assessment obligations	1,881,135	10.0	1,881,135	10.0
Industrial development and similar obligations	36,797	0.2	36,797	0.2
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	553,012	2.9	553,012	2.9
Issued or guaranteed by FNMA and FHLMC	4,227,858	22.5	4,227,858	22.5
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	1,400,707	7.4	1,400,707	7.4
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	5,568,962	29.6	5,568,962	29.6
Unaffiliated non-U.S. securities (including Canada)	816,297	4.3	816,297	4.3
Equity Interest				
Unaffiliated publicly traded equity securities (excluding preferred stocks)	917,328	4.9	917,328	4.9
Real estate investments:				
Property occupied by company	258,380	1.4	258,381	1.4
Property held for sale	60,860	0.3	60,860	0.3
Receivable for securities	192	—	192	—
Cash, cash equivalents, and short-term investments	155,161	0.8	155,161	0.8
Total cash and investments	\$ 18,851,247	100.0%	\$ 18,851,247	100.0%

See accompanying independent auditors' report.

**STATE COMPENSATION INSURANCE FUND**

## Supplemental Reinsurance Interrogatories

December 31, 2013

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.

## STATE COMPENSATION INSURANCE FUND

### Supplemental Reinsurance Interrogatories

December 31, 2013

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.