Financial Statements and Supplementary Information – Statutory Basis

State Compensation Insurance Fund
Years Ended December 31, 2016 and 2015
With Report of Independent Auditors

Ernst & Young LLP

Building a better working world

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Contents

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Report of Independent Auditors

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

We have audited the accompanying statutory-basis financial statements of State Compensation Insurance Fund, which comprise the statements of admitted assets, liabilities, and policyholders' surplus as of December 31, 2016, and the related statements of income and changes in policyholders' surplus, and cash flow for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with 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 of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit 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 meet the requirements of California, the financial statements have been prepared in conformity with accounting practices prescribed or permitted by the California Department of Insurance, which practices differ from U.S. generally accepted accounting principles. The variances between such practices and U.S. generally accepted accounting principles are described in Note 2. The effects on the accompanying financial statements of these variances are not reasonably determinable, but are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the effects of the matter described in the preceding paragraph, the statutory-basis financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of State Compensation Insurance Fund at December 31, 2016, or the results of its operations or its cash flows for the year then ended.

Opinion on Statutory Basis of Accounting

However, in our opinion, the statutory-basis financial statements referred to above present fairly, in all material respects, the financial position of State Compensation Insurance Fund at December 31, 2016, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the California Department of Insurance.

The statutory-basis financial statements of State Compensation Insurance Fund as of December 31, 2015, and for the year then ended, were audited by other auditors who expressed an adverse opinion on those statements as to their conformity with U.S. generally accepted accounting principles and an unmodified opinion on those statements as to their conformity with accounting practices prescribed or permitted by the California Department of Insurance on May 26, 2016.

Ernst + Young LLP

May 25, 2017

State Compensation Insurance Fund

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

	December 31	
	2016	**2015**
Admitted assets		
Bonds, at amortized cost	**$ 18,904,436**	$ 18,492,379
Common stocks	**895,418**	892,532
Real estate	**245,030**	247,847
Cash, cash equivalents, and short-term investments	**224,085**	61,805
Receivables for securities	**35**	701
Total cash and investments	**20,269,004**	19,695,264
Premiums in the course of collection	**90,603**	82,875
Earned but unbilled premiums	**136,128**	202,454
Reinsurance recoverables	**2,239**	13,974
Accrued interest and dividends	**133,539**	139,910
Guaranty fund receivables	**29,674**	26,176
Due from adjusting contracts	**45,623**	48,465
Other assets	**24,194**	20,278
Total admitted assets	**$ 20,731,004**	$ 20,229,396
Liabilities and policyholders' surplus		
Estimated liabilities for:		
Losses	**$ 11,131,546**	$ 10,945,630
Loss adjustment expenses	**1,776,869**	1,742,177
Retroactive reinsurance ceded	**(405,292)**	(414,464)
Unearned premiums	**76,266**	78,565
Dividends reserve	**100**	18,110
Other postemployment benefit liability	**731,277**	671,932
Borrowed money and interest thereon	**178,875**	172,574
Deposit liability	**133,970**	153,369
Self-insurance reserve	**150,282**	134,253
Other liabilities	**262,055**	187,811
Total liabilities	**14,035,948**	13,689,957
Special surplus funds for:		
Retroactive reinsurance	**405,292**	414,464
Unfunded pension and other postemployment benefits	**1,155,083**	1,654,124
Unassigned surplus	**5,134,681**	4,470,851
Policyholders' surplus	**6,695,056**	6,539,439
Total liabilities and policyholders' surplus	**$ 20,731,004**	$ 20,229,396

See accompanying notes to statutory-basis financial statements.

State Compensation Insurance Fund

Statements of Income
Statutory Basis
(In Thousands)

	Year Ended December 31	
	2016	**2015**
Net premiums earned	**$ 1,527,224**	$ 1,604,612
Losses incurred	**1,130,211**	1,251,597
Loss adjustment expenses incurred	**493,468**	453,829
Underwriting and administrative expenses	**381,871**	382,026
Total underwriting deductions	**2,005,550**	2,087,452
Net underwriting loss	**(478,326)**	(482,840)
Net investment income earned	**626,850**	642,254
Net realized capital gains	**69,268**	89,123
Other loss	**(30,915)**	(16,000)
Net income before dividends to policyholders	**186,877**	232,537
Dividends to policyholders	**(4,691)**	(38,321)
Net income	**$ 191,568**	$ 270,858

See accompanying notes to statutory-basis financial statements.

State Compensation Insurance Fund

Statements of Changes in Policyholders' Surplus
Statutory Basis
(In Thousands)

	Total
Balance, January 1, 2015	$ 6,375,166
Net income	270,858
Change in nonadmitted assets	(2,438)
Change in net unrealized capital gain	(65,143)
Unfunded actuarial accrued liability allocation	(38,600)
Change in provision for reinsurance	(404)
Balance, December 31, 2015	6,539,439
Net income	**191,568**
Change in nonadmitted assets	**(25,589)**
Change in net unrealized capital gain	**39,763**
Unfunded actuarial accrued liability allocation	**(44,144)**
Change in provision for reinsurance	**(5,981)**
Balance, December 31, 2016	**$ 6,695,056**

See accompanying notes to statutory-basis financial statements.

State Compensation Insurance Fund

Statements of Cash Flow
Statutory Basis
(In Thousands)

	Year Ended December 31	
	2016	**2015**
Operating activities		
Premiums collected net of reinsurance	**$ 1,506,567**	$ 1,561,513
Net investment income	**714,812**	714,919
Other income received	**16,464**	20,171
Benefits and loss-related payments	**(932,750)**	(1,005,506)
Other underwriting expenses	**(860,734)**	(892,130)
Net cash provided by operations	**444,359**	398,967
Investment activities		
Proceeds from investments sold, matured, or repaid:		
Bonds	**3,018,958**	2,420,893
Common stocks	**355,378**	442,190
Change in receivable for securities	**665**	(457)
Total investment proceeds	**3,375,001**	2,862,626
Cost of investments acquired:		
Bonds	**(3,483,635)**	(3,016,465)
Common stocks	**(272,503)**	(344,285)
Real estate	**(2,804)**	–
Change in payable for securities	**94,512**	(44,564)
Total investments acquired	**(3,664,430)**	(3,405,314)
Net cash used in investing activities	**(289,429)**	(542,688)
Financing and miscellaneous activities:		
Borrowed funds	**6,301**	75,445
Other cash provided	**1,049**	53,673
Net cash provided by financing and miscellaneous activities	**7,350**	129,118
Net change in cash, cash equivalents, and short-term investments	**162,280**	(14,603)
Cash and short-term investments, beginning of year	**61,805**	76,408
Cash and short-term investments, end of year	**$ 224,085**	$ 61,805
The Company reported the following noncash operating, investing, and financing activities (included as applicable) in 2016 and 2015:		
Depreciation	**$ 15,375**	$ 17,412
Special surplus funds (retroactive reinsurance, unfunded pension, and other postemployment benefit)	**(508,213)**	696,975
Premium charge-offs	**47,379**	36,170
Investments (amortization of premium, accrual of discount, unrealized gain/loss, and impairment)	**(39,148)**	(138,366)

See accompanying notes to statutory-basis financial statements.

1. History and Business

State Compensation Insurance Fund (State Fund or the Company) is a public enterprise fund established by the State of California (the State) 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 Section 11770 of the California Insurance Code (the Code). In accordance with the Code, the Board of Directors (BOD) 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 representing organized labor, and the Senate Committee on Rules shall appoint one member who has been a policyholder, or an officer, or an employee of a policyholder of State Fund.

State Fund's purpose is to provide fairly priced workers' compensation insurance, make workplaces safe, and restore injured workers. State Fund is self-supported with revenue from premiums written and 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

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 principles (GAAP) for State Fund are those promulgated by the Governmental Accounting Standards Board (GASB), which are the accounting standards applicable to state and local governmental entities.

2. Summary of Significant Accounting Policies (continued)

Statutory accounting practices differ in certain respects from GAAP, as prescribed by the GASB. The significant differences from GASB are as follows:

- Cash balances are reported net of bank overdrafts and outstanding checks and, in instances of net negative cash balance, amounts are reported as a negative asset rather than a liability.

- Investments 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 credited 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 of the following: premiums in the course of collection that 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; leasehold improvements; deposits held by others; and investment income due and accrued over 90 days. Under GASB, these assets would be included in total assets to the extent realizable.

- Gains on retroactive reinsurance are recognized in income and established as special surplus. GASB requires the gains to be deferred and recognized over the estimated settlement period of the reinsured losses using a recovery 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.

2. Summary of Significant Accounting Policies (continued)

- 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 recoverables over 90 days, plus all related amounts due that have been recorded on those reinsurance recoverables. 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 surplus to be restricted unless required by law.

- Accounting for contingencies requires recording a liability at the midpoint of a range of estimated possible outcomes, when no better estimate in the range exists; while GASB would require the minimum amount in the range to be accrued.

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

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 revenue and expenses during the reporting period. Actual results could differ materially from those estimates. Among the most significant estimates inherent in these statutory-basis financial statements are the liabilities for losses and loss adjustment expenses, and State Fund's portion of the pension and other postemployment benefit (OPEB) costs estimated by State Fund based on the current actuarial valuation prepared for the State.

2. Summary of Significant Accounting Policies (continued)

Cash, Cash Equivalents, and Short-Term Investments

Cash consists of cash, 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 include investments with remaining maturities of one year or less at the time of acquisition and are principally stated at cost, which approximates fair value.

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 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. Investments in common stocks are stated at fair value. Federal Home Loan Bank (FHLB) shares are valued at par, which is presumed to be fair value as they are only redeemable at par.

State Fund uses widely accepted cash flow models from third-party data providers, which use Median Speeds model. Median Speeds serves as a benchmark for MBS prepayment assumptions. This model looks to the specifics of the security dealers' own models. The data provider will scan all of 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.

2. Summary of Significant Accounting Policies (continued)

State Fund reviews its investment portfolio to determine whether or not declines in fair value of individual securities held are other than temporary. 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 MBSs, to the present value of expected cash flows if management has the ability and intent to hold the MBS to recovery of that amount and does not have the intent to sell the investment. If the Company intends to sell the MBS investment or loses the ability to hold it to recovery, the impairment charge is the full difference between the amortized cost and fair value. 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, the length of time and extent to which fair value has been less than cost, the financial condition and near-term prospects of the issuers, whether the debtor is current on its contractually obligated interest and principal payments, and management's intent and ability to hold the asset. If the decline is interest related, the Company considers whether it has an intent to sell, or lacks the ability to hold, the security to recovery.

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.

Realized capital gains or losses on bonds and common stocks are recognized on a first-in, first-out (FIFO) basis when securities are sold, redeemed, or otherwise disposed and reported as realized gains or losses in the statement of income. Unrealized gains and losses for assets carried at fair value are reflected in policyholders' surplus.

For bonds, interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period, reductions for premium amortization and interest paid on acquisitions 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.

2. Summary of Significant Accounting Policies (continued)

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).

Real Estate, Furniture, Equipment, and Leasehold Improvements

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. On a nonrecurring basis, real estate held for sale is measured at fair value due to impairment recognition. If impaired, State Fund books the lesser of cost or fair value. 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 (IDS) 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.

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 purchases of items such as electronic data processing equipment, vehicles, furniture, fixtures, equipment, IDS, and leasehold improvements.

2. Summary of Significant Accounting Policies (continued)

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 loss 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 BOD as required by CDI regulatory provisions.

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, frequency-severity, and historical loss ratios adjusted to current rate levels.

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.

2. Summary of Significant Accounting Policies (continued)

State Fund bills required deposits to policyholders based on a percentage of estimated annual premiums and records the deposit 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 of EBUB are not anticipated to be collected, they are written off against operations in the period that the determination is made.

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. State Fund considers anticipated investment income when determining the existence of a premium deficiency. As of December 31, 2016 and 2015, State Fund has no liabilities related to premium deficiency reserves.

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, all 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. The Loss Portfolio Transfer (LPT) agreement is accounted for as retroactive reinsurance in accordance with SSAP No. 62R, *Property and Casualty Reinsurance.*

2. Summary of Significant Accounting Policies (continued)

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 2016 and 2015 annual CIGA assessment was 2.0% and 1.83%, respectively, of direct written premium. The DIR assessment aggregates to approximately 1.0% and 1.45% of direct written premium for 2016 and 2015, 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 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 2.0% 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 prorated 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 $10,000 and $10,503, which are included in other liabilities as of December 31, 2016 and 2015, respectively, for future assessments under the Act.

2. Summary of Significant Accounting Policies (continued)

Pension and Other Postemployment Benefit Plans

State Fund employees are employees of 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 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 the normal cost each year (Normal Cost) and amortize any unfunded actuarial accrued 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 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.

Projected benefits for financial reporting purposes are based on the substantive plan and include 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 methodologies, assumptions, and results as of June 30, 2016 discussed herein were provided to State Fund by the State and were followed by

2. Summary of Significant Accounting Policies (continued)

State Fund's external pension actuary for projection of December 31, 2016 year-end reporting purposes.

The State's UAAL 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. To comply with GASB 68, CalPERS prepared an accounting valuation report for the State's net pension liabilities for the State's fiscal year ended June 30, 2016 (using a valuation date of June 30, 2015), including an allocation of State Fund's proportionate share of the State's net pension liability that State Fund is required to accrue. State Fund estimated the portion of the State's unfunded Pension and OPEB liabilities attributable to State Fund as of December 31, 2016 based on the assumptions and allocation percentages provided by the State for the Pension liability allocation. 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 the State's OPEB valuation report as of June 30, 2016, the individual entry-age normal actuarial cost method of valuation was used in determining liabilities and normal cost. A pay-as-you-go funding scenario was used by the State. 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 8.00% in 2018 graded down over five years until the ultimate rate of 4.50% is reached.

The full UAAL and 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 2016.

State Fund established a special surplus account to provide for the portion of the contingency for OPEB and pension costs that have not already been accrued as a liability, as permitted by SSAP No. 72, *Surplus and 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 potential future changes in 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 the estimate each year-end.

2. Summary of Significant Accounting Policies (continued)

State Fund recognizes in the statement of income 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 as a direct reduction to the special surplus account.

GASB No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other than Pension*, is effective for public employers' fiscal years beginning after June 15, 2017; earlier application is permissible. The primary objective of this Statement is to improve accounting and financial reporting by state and local governments for postemployment benefits other than pensions (other postemployment benefits or OPEB). The Statement establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures. For defined benefit OPEB, this Statement identifies the methods and assumptions that are required to be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. The Statement details the recognition and disclosure requirements for employers with payables to defined benefit OPEB plans that are administered through trusts that meet the specified criteria. In anticipation of CalPERS future implementation of GASB 75, State Fund engaged a third-party actuary to estimate State Fund's proportionate share of the net OPEB liability. The UAAL adjustment resulting from GASB No. 75 assessment is recorded as a direct addition to the special surplus account.

Income Taxes

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

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, 2016 and 2015, policyholders' surplus exceeded the minimum RBC requirements.

(Dollars in Thousands)

4. Investment Securities

State Fund's investments are comprised of bonds and common stocks.

Bonds

The carrying value, gross unrealized gains and losses, and fair value of investments in bonds as of December 31, 2016 and 2015 are as follows:

	2016			
	Carrying Value	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
All other governments	**$ 125,916**	**$ 404**	**$ (289)**	**$ 126,032**
Industrial and miscellaneous	**7,959,376**	**143,492**	**(61,833)**	**8,041,035**
Political subdivisions	**281,350**	**25,148**	**(463)**	**306,035**
Special revenue/assessment	**2,492,536**	**155,636**	**(7,444)**	**2,640,728**
States, territories, and possessions	**233,200**	**29,404**	**(574)**	**262,030**
U.S. Government	**508,181**	**17,620**	**(57)**	**525,744**
Mortgage-backed securities:				
Special revenue/assessment	**6,531,233**	**89,853**	**(69,477)**	**6,551,609**
U.S. Government	**772,644**	**27,280**	**(6,129)**	**793,794**
Total	**$ 18,904,436**	**$ 488,837**	**$ (146,266)**	**$ 19,247,007**

	2015			
	Carrying Value	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
All other governments	$ 193,952	$ 4,588	$ (192)	$ 198,348
Industrial and miscellaneous	7,398,385	152,050	(72,549)	7,477,886
Political subdivisions	299,182	29,378	(317)	328,243
Special revenue/assessment	2,570,479	177,019	(5,797)	2,741,701
States, territories, and possessions	269,598	29,027	(354)	298,271
U.S. Government	786,250	32,826	(521)	818,555
Mortgage-backed securities:				
Special revenue/assessment	6,145,124	128,483	(34,849)	6,238,758
U.S. Government	829,409	42,442	(2,939)	868,912
Total	$ 18,492,379	$ 595,813	$ (117,518)	$ 18,970,674

(Dollars in Thousands)

4. Investment Securities (continued)

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2016 and 2015:

	2016					
	12 Months or Under		**Over 12 Months**		**Total**	
	Fair Value	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**
All other governments	**$ 34,681**	**$ (289)**	**$ –**	**$ –**	**$ 34,681**	**$ (289)**
Industrial and miscellaneous	**3,009,160**	**(60,231)**	**29,135**	**(1,602)**	**3,038,295**	**(61,833)**
Political subdivisions	**35,518**	**(463)**	**–**	**–**	**35,518**	**(463)**
Special revenue/assessment	**385,868**	**(7,444)**	**–**	**–**	**385,868**	**(7,444)**
States, territories, and possessions	**26,716**	**(574)**	**–**	**–**	**26,716**	**(574)**
U.S. Government	**29,978**	**(57)**	**–**	**–**	**29,978**	**(57)**
Mortgage-backed securities:						
Special revenue/assessment	**3,647,006**	**(68,922)**	**24,612**	**(555)**	**3,671,618**	**(69,477)**
U.S. Government	**332,703**	**(6,129)**	**–**	**–**	**332,703**	**(6,129)**
Total	**$ 7,501,630**	**$ (144,109)**	**$ 53,747**	**$ (2,157)**	**$ 7,555,377**	**$ (146,266)**

	2015					
	12 Months or Under		**Over 12 Months**		**Total**	
	Fair Value	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**
All other governments	$ 29,793	$ (192)	$ –	$ –	$ 29,793	$ (192)
Industrial and miscellaneous	3,132,246	(66,152)	103,908	(6,397)	3,236,154	(72,549)
Political subdivisions	36,369	(317)	–	–	36,369	(317)
Special revenue/assessment	354,633	(5,797)	–	–	354,633	(5,797)
States, territories, and possessions	19,936	(354)	–	–	19,936	(354)
U.S. Government	39,518	(521)	–	–	39,518	(521)
Mortgage-backed securities:						
Special revenue/assessment	2,238,117	(27,068)	206,744	(7,781)	2,444,861	(34,849)
U.S. Government	85,414	(383)	82,665	(2,556)	168,079	(2,939)
Total	$ 5,936,026	$ (100,784)	$ 393,317	$ (16,734)	$ 6,329,343	$ (117,518)

As of December 31, 2016 and 2015, 760 and 517 securities were in an unrealized loss position, which resulted in an unrealized loss of $146,266 and $117,518, respectively. As of December 31, 2016 and 2015, the unrealized loss position was attributed to the increase in interest rates over the course of 2016 and 2015. This led to a downward price movement across all sectors in the

(Dollars in Thousands)

4. Investment Securities (continued)

bond portfolio. State Fund's bond portfolio is primarily comprised of investment grade securities. As of December 31, 2016 and 2015, 93% and 96%, respectively, of all bonds held by State Fund were rated Class 1 by the NAIC. State Fund concluded that the gross unrealized losses as of December 31, 2016 and 2015 were temporary in nature.

The carrying value and fair value of bonds as of December 31, 2016, 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.

	2016	
	Carrying Value	**Fair Value**
Due in one year or less	$ 1,096,152	$ 1,110,926
Due after one year through five years	4,709,084	4,814,048
Due after five years through ten years	3,565,411	3,597,229
Due after ten years	2,229,912	2,379,401
Mortgage-backed securities	7,303,877	7,345,403
Total	$ 18,904,436	$ 19,247,007

Proceeds from sales of bonds during 2016 were $708,663 with gross realized gains of $30,988 and gross realized losses of $7,366.

Proceeds from sales of bonds during 2015 were $517,133 with gross realized gains of $24,570 and gross realized losses of $412.

State Fund recognized other-than-temporary impairments of $0 and $575 on bonds for the years ended December 31, 2016 and 2015, respectively.

(Dollars in Thousands)

4. Investment Securities (continued)

State Fund had $66,684 and $66,785 on deposit with the Federal Reserve Bank of St. Louis as of December 31, 2016 and 2015, respectively, to satisfy the U.S. Department of Labor regulations relating to State Fund's issuance of U.S. L&H policies.

Common Stocks

The tables below reflect costs, gross unrealized gains and losses, and fair value of investments in common stocks as of December 31, 2016 and 2015:

	2016			
	Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Industrial and miscellaneous	**$ 762,991**	**$ 143,741**	**$ (11,314)**	**$ 895,418**
Total common stocks	**$ 762,991**	**$ 143,741**	**$ (11,314)**	**$ 895,418**

	2015			
	Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Industrial and miscellaneous	$ 799,868	$ 120,255	$ (27,591)	$ 892,532
Total common stocks	$ 799,868	$ 120,255	$ (27,591)	$ 892,532

(Dollars in Thousands)

4. Investment Securities (continued)

The tables below reflect the summary of temporarily impaired common stocks as of December 31, 2016 and 2015:

	2016					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Industrial and miscellaneous	**$ 142,227**	**$ (10,441)**	**$ 12,452**	**$ (873)**	**$ 154,679**	**$ (11,314)**
Total common stocks	**$ 142,227**	**$ (10,441)**	**$ 12,452**	**$ (873)**	**$ 154,679**	**$ (11,314)**

	2015					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Industrial and miscellaneous	$ 203,794	$ (22,232)	$ 12,131	$ (5,359)	$ 215,925	$ (27,591)
Total common stocks	$ 203,794	$ (22,232)	$ 12,131	$ (5,359)	$ 215,925	$ (27,591)

As part of its assessment of other-than-temporary impairments, the Company considers its intent to continue to hold and the likelihood that it will not be required to sell investment securities in an unrealized loss position until cost recovery. Factors to consider include, but are not limited to, debt burden, credit ratings, sector liquidity, financial flexibility, company management, expected earnings and cash flow stream, and economic prospects associated with the investment.

Proceeds from sales or disposals of common stocks during 2016 were $355,378 with gross realized gains of $62,505 and gross realized losses of $13,487. Proceeds from sales or disposals of common stocks during 2015 were $442,190 with gross realized gains of $81,173 and gross realized losses of $15,305.

State Fund recognized other-than-temporary impairments of $3,020 and $3,919 on common stocks for the years ended 2016 and 2015, respectively.

(Dollars in Thousands)

4. Investment Securities (continued)

State Fund purchased $25,000 of FHLB common stock as an initial requirement to become a member of the FHLB of San Francisco. In 2015, State Fund redeemed $7,750 of FHLB common stock. This Class B membership stock's current cost is $17,250. FHLB shares are valued at par and not publicly traded.

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, 2016 and 2015, State Fund has no direct subprime mortgage-related risk exposure. State Fund does invest primarily in MBS that are backed by government agencies or government-sponsored entities, specifically GNMA, FNMA, and FHLMC. These types of securities are collateralized by loans, but are ultimately backed by the issuing agency. GNMA securities are guaranteed by the U.S. Treasury. State Fund, as well as other State and Local Agencies, are authorized to invest funds in the State's Pooled Money Investment Account (PMIA). State Fund's holdings in the PMIA at December 31, 2016 and 2015 were $65,545 and $26,982, respectively.

The tables below summarize State Fund's Structured Notes as of December 31, 2016 and 2015 which are included in industrial and miscellaneous bonds:

	2016			
Description	CUSIP Identification	Actual Cost	Fair Value	Book/Adjusted Carrying Value
Bank of New York Mellon	064058AA8	**$ 5,094**	**$ 5,087**	**$ 5,072**
Metlife Inc	59156RBK3	**3,009**	**3,008**	**3,003**
Total		**$ 8,103**	**$ 8,095**	**$ 8,075**

	2015			
Description	CUSIP Identification	Actual Cost	Fair Value	Book/Adjusted Carrying Value
Bank of New York Mellon	064058AA8	$ 5,093	$ 5,098	$ 5,077
Metlife Inc	59156RBK3	3,009	3,018	3,006
Wells Fargo & Company	949746QU8	5,915	5,948	5,878
E I Du Pont De Nemours and Co	263534CK3	31,189	29,647	31,192
Total		$ 45,206	$ 43,711	$ 45,153

(Dollars in Thousands)

4. Investment Securities (continued)

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

	2016	2015
Bonds	**$ 618,073**	$ 635,647
Common stocks	**23,691**	25,805
Real estate	**26,136**	25,000
Other	**436**	126
Total investment income	**668,336**	686,578
Less investment expenses	**(41,486)**	(44,324)
Net investment income	**$ 626,850**	$ 642,254

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, *Fair Value*. 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

(Dollars in Thousands)

5. Fair Value Measurement (continued)

The tables below summarize State Fund's fair value of financial instruments by Level 1, 2 and 3:

	December 31, 2016			
	Level 1	**Level 2**	**Level 3**	**Total**
Financial assets:				
Bonds	**$ –**	**$ 19,236,718**	**$ 10,289**	**$ 19,247,007**
Common stocks	**848,996**	**17,250**	**29,172**	**895,418**
Cash, cash equivalents, and short-term investments	**224,085**	**–**	**–**	**224,085**
Receivables for securities	**35**	**–**	**–**	**35**
Total	**$ 1,073,116**	**$ 19,253,968**	**$ 39,461**	**$ 20,366,545**
Financial liabilities:				
Borrowed money and interest thereon	**$ –**	**$ 178,486**	**$ –**	**$ 178,486**
Payables for securities	**94,863**	**–**	**–**	**94,863**
Total	**$ 94,863**	**$ 178,486**	**$ –**	**$ 273,349**

	December 31, 2015			
	Level 1	**Level 2**	**Level 3**	**Total**
Financial assets:				
Bonds	$ –	$ 18,960,061	$ 10,613	**$ 18,970,674**
Common stocks	848,578	17,250	26,704	**892,532**
Cash, cash equivalents, and short-term investments	61,805	–	–	**61,805**
Receivables for securities	701	–	–	**701**
Total	$ 911,084	$ 18,977,311	$ 37,317	**$ 19,925,712**
Financial liabilities:				
Borrowed money and interest thereon	$ –	$ 171,815	$ –	**$ 171,815**
Payables for securities	351	–	–	**351**
Total	$ 351	$ 171,815	$ –	**$ 172,166**

(Dollars in Thousands)

6. Borrowed Money

State Fund has pledged bonds to FHLB in exchange for cash advances to utilize for operations and investment in medium-term bonds. Under the Securities Backed Credit Program, members of the FHLB may borrow up to 100% of the current market value of its eligible securities pledged. FHLB assigned the appropriate borrowing capacity to each security according to the security type and then determines the total borrowing capacity as a percentage of the market value of the Securities Backed Credit collateral. The current borrowing of $178,538 is subject to prepayment penalties.

The table below summarizes the FHLB pledge and borrowing:

	2016	2015
Actual or estimated borrowing capacity as of reporting date	**$ 803,025**	$ 727,396
Collateral amount pledged as of reporting date:		
Fair value	**1,103,717**	986,934
Carrying value	**1,073,228**	938,511
Maximum collateral amount pledged during the reporting period:		
Fair value	**1,214,246**	1,036,720
Carrying value	**1,160,349**	968,302
Maximum amount borrowed during the reporting period	**178,538**	229,117
Borrowing from FHLB as of reporting date	**178,538**	172,291
Accrued interest on borrowing	**337**	283
Total borrowing and accrued interest	**$ 178,875**	$ 172,574

(Dollars in Thousands)

6. Borrowed Money (continued)

The tables below summarize the date issued, maturity date, face value, carrying value, interest rate and effective interest rate, and interest paid related to the FHLB borrowing agreement:

December 31, 2016

Date Issued	Maturity Date	Face Value/ Carrying Value	Interest Rate	Effective Interest Rate	Interest Paid
05/29/13	05/22/18	**$ 39,500**	**1.285%**	**1.285%**	**$ 507**
06/04/13	05/22/18	**9,713**	**1.335**	**1.335**	**130**
06/30/15	01/24/19	**25,200**	**1.578**	**1.578**	**398**
08/11/15	03/26/18	**25,000**	**1.200**	**1.200**	**299**
08/14/15	07/22/20	**25,078**	**1.757**	**1.757**	**441**
08/29/16	08/07/20	**14,372**	**1.293**	**1.293**	**63**
09/02/16	08/07/20	**9,226**	**1.334**	**1.334**	**40**
09/02/16	08/07/20	**5,126**	**1.328**	**1.328**	**22**
09/14/16	08/07/20	**20,496**	**1.333**	**1.333**	**81**
11/02/16	06/17/19	**4,827**	**1.160**	**1.160**	**9**
Total		**$ 178,538**			**$ 1,990**

December 31, 2015

Date Issued	Maturity Date	Face Value/ Carrying Value	Interest Rate	Effective Interest Rate	Interest Paid
04/10/13	01/22/16	$ 25,000	0.536%	0.536%	$ 135
04/16/13	01/22/16	22,800	0.507	0.507	116
05/29/13	05/22/18	39,500	1.285	1.285	511
06/04/13	05/22/18	9,713	1.335	1.335	130
06/30/15	01/24/19	25,200	1.578	1.578	207
08/11/15	03/26/18	25,000	1.197	1.197	122
08/14/15	07/22/20	25,078	1.757	1.757	173
Total		$ 172,291			$ 1,394

Based on the advance agreement, State Fund is subject to normal covenants of compliance with the FHLB credit program, compliance with applicable laws, providing reports as FHLB may require, insurance on the collateral, and notices for specified events such as defaults, mergers, change in charter, etc. There have been no violations of the terms and covenants for the advances.

(Dollars in Thousands)

7. Real Estate, Furniture, Equipment, and Leasehold Improvements

Real estate as of December 31, 2016 and 2015 is comprised of the following:

	2016	2015
Property occupied by the Company	**$ 314,922**	$ 312,117
Property held for sale	**710**	710
	315,632	312,827
Accumulated depreciation	**(70,602)**	(64,980)
Total	**$ 245,030**	$ 247,847

Depreciation expense on real estate was $5,622 for each of the years ended December 31, 2016 and 2015. As of December 31, 2016 and 2015, State Fund did not impair real estate property held for sale.

Furniture, equipment, and leasehold improvements as of December 31, 2016 and 2015 comprise the following:

	2016	2015
Data processing equipment and software	**$ 313,574**	$ 307,893
Office furniture, equipment, and leasehold improvements	**54,873**	54,568
	368,447	362,461
Accumulated depreciation	**(351,490)**	(343,296)
	16,957	19,165
Nonadmitted assets	**(7,484)**	(8,918)
Total	**$ 9,473**	$ 10,247

Depreciation and amortization expenses on furniture, equipment, and leasehold improvements were $9,818 and $11,827 for the years ended December 31, 2016 and 2015, respectively.

(Dollars in Thousands)

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, 2016 and 2015. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of an LPT.

	2016	2015
Estimated liabilities for losses and loss adjustment expenses as of January 1, 2016 and 2015, net of ceded reinsurance of $49,548 and $67,208, respectively	**$ 12,687,807**	$ 12,431,814
Add incurred related to:		
Current year	**1,614,498**	1,700,408
Prior years	**9,181**	5,018
Total incurred	**1,623,679**	1,705,426
Less paid related to:		
Current year	**245,102**	256,816
Prior years	**1,157,969**	1,192,617
Total paid	**1,403,071**	1,449,433
Estimated liabilities for losses and loss adjustment expenses as of December 31, 2016 and 2015, net of ceded reinsurance of $43,264 and $49,548, respectively	**$ 12,908,415**	$ 12,687,807

The increase in incurred losses and loss adjustment expenses relating to insured events in prior years were approximately $9,181 and $5,018 in 2016 and 2015, respectively. The unfavorable 2016 incurred losses related to prior year of $3,364 is due to a decrease in reinsurance recoverable during the year and the unfavorable 2016 incurred LAE of $5,817 is due to the increase in the liability for the Company's own legally uninsured workers' compensation program. The unfavorable 2015 incurred losses related to prior year of $280 was due to a decrease in reinsurance recoverable during the year and the unfavorable 2015 incurred LAE of $4,738 was due to the increase in the liability for the Company's own legally uninsured workers' compensation program.

8. Estimated Liabilities for Losses and Loss Adjustment Expenses (continued)

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 (SB 863 reform), Medicare set-aside requirements, medical inflation, and changes in the utilization of medical procedures.

Subrogation recoveries are considered when setting loss reserves. The estimated subrogation included as a reduction to IBNR was $38,566 and $34,298 as of December 31, 2016 and 2015, respectively.

State Fund had a significant increase in business volume during the 2002–2004 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 since 2013. Over time, this risk should diminish as the pricing tier structure matures.

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 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 March 2010, the Affordable Care Act of 2010 (Affordable Care Act), was signed into law. The Affordable Care Act impacts healthcare costs and delivery. Since healthcare is the largest component of State Fund's loss costs, this legislation may indirectly impact State Fund, although

(Dollars in Thousands)

8. Estimated Liabilities for Losses and Loss Adjustment Expenses (continued)

the impact, if any, is uncertain. 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 potential cost-saving efficiencies. The bill became effective January 1, 2013. The full impact of SB 863 on incurred and unpaid claims is uncertain.

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 reserve estimation, 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:

	2016	2015
Asbestos, direct:		
Beginning reserves (including case, bulk and IBNR, and LAE)	**$ 43,012**	$ 45,403
Losses and LAE incurred	**–**	–
Calendar year payments for losses and LAE	**(2,545)**	(2,391)
Ending reserves (including case, bulk and IBNR, and LAE)	**$ 40,467**	$ 43,012
Asbestos, assumed	**$ –**	$ –
Asbestos, net of ceded:		
Beginning reserves (including case, bulk and IBNR, and LAE)	**$ 39,269**	$ 41,403
Losses and LAE incurred	**1,871**	–
Calendar year payments for losses and LAE	**(2,406)**	(2,134)
Ending reserves (including case, bulk and IBNR, and LAE)	**$ 38,734**	$ 39,269

(Dollars in Thousands)

8. Estimated Liabilities for Losses and Loss Adjustment Expenses (continued)

The Company has purchased annuities form life insurers under which the claimants are payees. 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 present value of purchased annuities as reported to State Fund by the issuers was $817,699 and $903,348 at December 31, 2016 and 2015, respectively. This represents the discounted amount, as the nominal amount is not currently readily available from the issuers. These annuities have been used to reduce unpaid losses. State Fund is contingently liable for 100% of the annuities should the issuers of the annuities fail to perform under the terms of the annuities, which would require State Fund to report these obligations at the nominal value.

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 years ended December 31, 2016 and 2015, State Fund has reported ceded reinsurance balances (prior to the LPT) as follows:

	2016	2015
Reinsurance ceded:		
Premium written	**$ 14,843**	$ 15,415
Premium earned	**14,843**	15,415
Premium receivable	**(1,135)**	(984)
Loss and loss adjustment expense (recovered) incurred	**(7,381)**	13,548
Loss and loss adjustment expense reserve	**43,264**	49,548

Ceded loss and loss adjustment expense reserves include $31,195 and $38,126 recoverable from Reliastar Life Insurance Company as of December 31, 2016 and 2015, respectively.

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), authorized or unauthorized, that exceeds 3% of its policyholders' surplus.

9. Reinsurance (continued)

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 attempt 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 attempt to 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, the reinsured risks are reflected net of the related loss and loss adjustment expense reserves. State Fund, however, is responsible for the insurance ceded to the extent that reinsurers would be unable to meet the obligations assumed under reinsurance contracts.

For all natural catastrophes in 2016 and 2015, State Fund was covered by per occurrence excess of loss reinsurance for $300 million of losses in excess of $350 million for a catastrophe involving at least 24 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 2016 and 2015 by a multiyear catastrophe bond issued by a special purpose reinsurer that would provide up to $250 million for 2016 and 2015 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 actual ultimate losses and loss adjustment expenses or the modeled losses. The proceeds on the notes will

9. Reinsurance (continued)

be held in trust to collateralize the agreement with State Fund and in events of claims, State Fund can draw on the collateral. This catastrophe bond had the potential to cover losses for earthquakes with a magnitude greater than or equal to Mw 5.5 for the period September 17, 2014 until December 31, 2018.

For terrorism incidents in 2016, including losses generated from nuclear, biological, chemical, or radiological events, State Fund was covered by a combination of private reinsurance and the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA). A private per occurrence excess of loss reinsurance treaty covered $235 million of losses in excess of $100 million not first covered under TRIPRA, for an incident involving at least seven claimants. TRIPRA provided coverage for 84% of losses in excess of 20% of 2015 Direct Earned Premium, or approximately $325 million, subject to a statutorily determined industry-wide maximum.

For terrorism incidents in 2015, including losses generated from nuclear, biological, chemical, or radiological events, State Fund was covered by a combination of private reinsurance and the TRIPRA. A private per occurrence excess of loss reinsurance treaty covered $138 million of losses in excess of $200 million not first covered under TRIPRA, for an incident involving at least 14 claimants. TRIPRA provided coverage for 85% of losses in excess of 20% of 2014 Direct Earned Premium, or approximately $337 million, subject to a statutorily determined industry-wide maximum.

Commutation

For the year ended, December 31, 2016, State Fund has no commutation of ceded reinsurance.

(Dollars in Thousands)

9. Reinsurance (continued)

For the year ended December 31, 2015, State Fund commuted reinsurance recoverable on unpaid losses and loss adjustment expenses of $10,181, which included $9,987 of losses incurred and $194 of loss adjustment expenses, from the reinsurers listed below. State Fund’s commutation settlement proceeds, net of reinsurance recoverable, on paid losses and loss adjustment expenses was $9,075. The net effect of the commutation was an increase in losses and loss adjustment expenses of $1,106.

Sentry Insurance Company	$	(4)
Federal Insurance Company		1,110
Total	$	1,106

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 across the entire 18-year period. 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.

9. Reinsurance (continued)

As of 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 began to exceed LPT consideration paid. The special surplus for retroactive reinsurance was reduced by $9,172 in 2016 and $51,425 in 2015 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 claims involved in the LPT.

As of December 31, 2016, cumulative subject paid losses were $2,204,727, which exceeded the upper limit of the first layer of $2,100,000 placed at 90%. After the $950,000 Company retention, total billed losses were $1,035,000, of which $899,708 was collected from the Reinsurers, $2,293 was billed as a current receivable, and $132,999 was receivable but not yet due from deferred large loss settlements. As of December 31, 2015, cumulative subject paid losses were $2,144,055, which exceeded the upper limit of the first layer of $2,100,000 placed at 90%. After the $950,000 Company retention, total billed losses were $1,035,000, of which $890,536 was collected from the Reinsurers, $2,293 was billed as a current receivable, and $142,171 was receivable but not yet due from deferred large loss settlements.

(Dollars 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, 2016, were as follows:

Year:	
2017	$ 12,489
2018	12,216
2019	12,170
2020	12,092
2021	11,831
Future years	33,803
Total	$ 94,601

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, 2016 and 2015, the total rental expense for office space was $31,889 and $32,346, respectively, which is comprised of an allocation of rental value to space owned and occupied by State Fund of $21,732 and $20,282, and expense for leased properties of $10,157 and $12,064, respectively. Other lease expenses were $733 and $980 for the years ended December 31, 2016 and 2015, 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.

(Dollars in Thousands)

11. Pension and Other Postemployment Benefit Plans

State Fund incurred pension expense of $73,924 and $66,719 for the years ended December 31, 2016 and 2015, respectively.

State Fund paid retiree health benefit pro rata assessments of $25,652 and $18,609 for the years ended December 31, 2016 and 2015, respectively. The following table shows the components of State Fund's allocation of the State's 2016 and 2015, ARC, OPEB cost, the amount credited to the plan, and changes in the net OPEB obligation as of December 31, 2016 and 2015:

	2016	2015
Annual required contribution	**$ 96,325**	$ 91,414
Adjustment to annual required contribution	**(11,328)**	(16,721)
Annual OPEB cost	**84,997**	74,693
Estimated contribution credit	**(25,652)**	(18,609)
Increase in net OPEB obligation	**59,345**	56,084
Net OPEB obligation beginning of year	**671,932**	615,848
Net OPEB obligation end of year	**$ 731,277**	$ 671,932

The percentage of annual OPEB costs contributed to the plan was 30% and 25% for 2016 and 2015, respectively.

In 2016, State Fund continued to engage an outside third party for retirement actuarial consulting services to project the impact on Statutory accounting of GASB 68, *Accounting and Financial Reporting for Pensions* and GASB 75, *Accounting and Financial Reporting for Postemployment Benefits Other than Pension*. After reviewing the current funding status for pension, projected investment return rates, an overview of assets and liabilities, and discussions with stakeholders, State Fund lowered the discount rate from 7.65% to 7.00% as of December 31, 2016, which increased the special surplus for UAAL for pension by $142,000. Given the statewide OPEB prefunding that was negotiated through the state collective bargaining process and based on the current proportionate share of State Fund payroll and active employee health costs for the services provided to the State under a Master Service Agreement (MSA), State Fund reduced its estimate of the special surplus fund for unfunded pension and postemployment benefits by $212,837 and $384,060, respectively, which represented the contingent liability for State Fund employees who are assigned to the State Contracts operations at State Fund. These State Fund employees adjust

11. Pension and Other Postemployment Benefit Plans (continued)

and administer the workers' compensation claims for various state government agencies pursuant to the MSA entered into by California Department of Human Resources (CalHR) on behalf of a number of state agencies. The pension and OPEB costs for these State Fund employees are the responsibility of CalHR and the government agencies whose workers' compensation claims have been adjusted by State Fund.

In 2015, State Fund engaged an outside third party for retirement actuarial consulting services to project the impact on Statutory accounting in order to reassess State Fund's UAAL for the pension and OPEB as a result of CalPERS' implementation of GASB 68 and the anticipated future implementation of GASB 75. Due to the increase of State's UAAL as a whole and a new selection of actuarial assumptions applicable to the Company's operations, State Fund segregated an additional $582,000 and $205,000 from its surplus to its special surplus for UAAL for pension and OPEB, respectively.

State Fund's annual OPEB cost is based on the ARC as determined by the State, 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 2016, State Fund recorded OPEB expenses of $40,853 and reduced special surplus by $44,144. In 2015, State Fund recorded OPEB expenses of $36,093 and reduced special surplus by $38,600.

12. 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.

State Fund invests in various investment securities that 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. A substantial amount of the State Fund's assets are invested in debt and

12. Risks and Uncertainties (continued)

equity securities. Defaults, downgrades, or other events impairing the value of securities owned may reduce policyholders' surplus. 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.

State Fund attempts to protect its computer systems and communications systems but may experience interruptions and breaches, including computer viruses, malicious software, cyber-attacks, and hacking, which could impair the ability to conduct business and communicate, internally and with policyholders and customers, or result in the theft of trade secrets or other misappropriation of assets, or otherwise compromise privacy of State Fund's sensitive information, or that of its customers or other business partners.

Refer to Note 8 for discussion of the risks and uncertainties regarding estimates of reserves for losses and loss adjustment expenses incurred but unpaid. Refer to Note 2 for discussion of the risks and uncertainties regarding estimates of contingent obligations for unfunded pension and OPEB.

13. Related Parties

State Fund has an agreement with CalHR 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 adjusting. State Fund also bills monthly service fees for processing these claims on a full cost recovery basis. State Fund records a receivable for the reimbursements and monthly service fees 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 in the statements of admitted assets, liabilities, and policyholders' surplus.

(Dollars in Thousands)

14. Special Surplus Funds

The following summarizes changes in the balances of special surplus funds for 2016:

	Retroactive Reinsurance	Unfunded Pension and OPEB
Balance at December 31, 2015	**$ 414,464**	**$ 1,654,124**
Transfer from recoveries under LPT	**(9,172)**	**–**
Transfer to OPEB liability (Note 11)	**–**	**(44,144)**
Transfer to unassigned surplus (Note 11)	**–**	**(454,897)**
Balance at December 31, 2016	**$ 405,292**	**$ 1,155,083**

The following summarizes changes in the balances of special surplus funds for 2015:

	Retroactive Reinsurance	Unfunded Pension and OPEB
Balance at December 31, 2014	$ 465,889	$ 905,724
Transfer from recoveries under LPT	(51,425)	–
Transfer to OPEB liability (Note 11)	–	(38,600)
Transfer from unassigned surplus (Note 11)	–	787,000
Balance at December 31, 2015	$ 414,464	$ 1,654,124

15. Other Matters

The CDI is currently conducting their financial examination of the Company for the years ended December 31, 2013, 2014, 2015 and 2016, and is expected to be completed by 2018.

16. Subsequent Events

Management of State Fund has evaluated all events occurring after December 31, 2016 through May 25, 2017, the date the financial statements were available to be issued, to determine whether any events required either recognition or disclosure in the financial statements. In March 2017, State Fund sold stocks amounting to $297,706 due to changes in investment strategy. The sale resulted in a realized gain of $66,620.

Supplementary Information
Statutory Basis

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Report of Independent Auditors on Supplementary Information

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

Our audits were conducted for the purpose of forming an opinion on the statutory-basis financial statements as a whole. The accompanying supplemental investment disclosures and reinsurance disclosures are presented to comply with the National Association of Insurance Commissioners' *Annual Statement Instructions* and the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and for purposes of additional analysis and are not a required part of the financial statements. 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 audit of the statutory-basis 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. In our opinion, the information is fairly stated, in all material respects, in relation to the financial statements as a whole.

This report is intended solely for the information and use of State Compensation Insurance Fund (the Company) and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

May 25, 2017

State Compensation Insurance Fund

Supplemental Summary Investment Schedule

(Dollars in Thousands)

December 31, 2016

	Gross Investment Holdings		Admitted Assets as in the Annual Statement	
	Amount	Percentage	Amount	Percentage
State Fund had the following invested assets as of December 31, 2016				
Bonds:				
U.S. Treasury securities	$ 508,181	2.6 %	$ 508,181	2.6 %
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government-sponsored agencies	611,414	3.0	611,414	3.0
Non-U.S. government (including Canada, excluding mortgage-backed securities)	125,916	0.6	125,916	0.6
Securities issued by states, territories, and possessions, and political subdivisions in the United States:				
States, territories, and possessions general obligations	233,200	1.2	233,200	1.2
Political subdivisions of states, territories, and possessions and political subdivisions general obligations	281,350	1.4	281,350	1.4
Revenue and assessment obligations	1,842,473	9.1	1,842,473	9.1
Industrial development and similar obligations	35,825	0.2	35,825	0.2
Mortgage-backed securities (includes residential and commercial mortgage-backed securities):				
Pass-through securities:				
Issued or guaranteed by GNMA	338,165	1.7	338,165	1.7
Issued or guaranteed by FNMA and FHLMC	4,988,853	24.6	4,988,853	24.6
All other	1,688	–	1,688	–
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	1,975,171	9.7	1,975,171	9.7
All other				
Other debt and other fixed-income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans and	6,878,345	33.9	6,878,345	33.9
hybrid securities)	1,083,855	5.3	1,083,855	5.3
Unaffiliated non-U.S. securities (including Canada)				
Equity interest:				
Unaffiliated publicly traded equity securities (excluding preferred stocks)	866,246	4.3	866,246	4.3
Unaffiliated other equity securities	29,172	0.1	29,172	0.1
Real estate investments:				
Property occupied by company	244,320	1.2	244,320	1.2
Property held for sale	710	–	710	–
Receivable for securities	35	–	35	–
Cash, cash equivalents, and short-term investments	224,085	1.1	224,085	1.1
Total cash and investments	$ 20,269,004	100.0 %	$ 20,269,004	100.0 %

See accompanying independent auditors' report.

State Compensation Insurance Fund

Supplemental Investment Risks Interrogatories
(Dollars in Thousands)

December 31, 2016

State Fund's total admitted assets as filed in the 2016 Annual Statement is: $ 20,731,004

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

Issuer	Description of Exposure	Amount	Percentage of Total Admitted Assets
JPMorgan Chase & Co.	Industrial and miscellaneous	$ 233,611	1.1%
Wells Fargo & Company	Industrial and miscellaneous	195,927	0.9
PepsiCo, Inc.	Industrial and miscellaneous	158,397	0.8
Merck & Co., Inc.	Industrial and miscellaneous	153,229	0.7
The Coca-Cola Company	Industrial and miscellaneous	139,871	0.7
Apple Inc.	Industrial and miscellaneous	136,291	0.7
Duke Energy Corporation	Industrial and miscellaneous	130,393	0.6
UnitedHealth Group Incorporated	Industrial and miscellaneous	132,588	0.6
Chevron Corporation	Industrial and miscellaneous	126,771	0.6
Morgan Stanley	Industrial and miscellaneous	122,900	0.6

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	$ 17,669,464	85.2%
NAIC – 2	1,234,972	6.0
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 are 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.

State Compensation Insurance Fund

Supplemental Reinsurance Interrogatories
(Dollars in Thousands)

December 31, 2016

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. Other than 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.

(g) Exception relative to (2): 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 percent (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.

Supplemental Reinsurance Interrogatories (continued)

(Dollars in Thousands)

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.

Supplemental Reinsurance Interrogatories (continued)

(Dollars in Thousands)

1. Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)? Yes [ ] No [X]
2. If yes, indicate the number of reinsurance contracts containing such provisions.
3. If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? Yes [ ] No [ ]
4. Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured? Yes [ ] No [X]
5. If yes, give full information.
6. Has the reporting entity 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 yearend 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 a 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 noncancellable by the reporting entity during the contract term;
   (b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
   (c) Aggregate stop loss reinsurance coverage;
   (d) A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions which are only triggered by a decline in the credit status of the other party;

(Dollars in Thousands)

(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. Yes [X] No [ ]

(A) Financial Impact			
	As Reported	**Reinsurance Effect**	**Restated Without Reinsurance**
A01. Assets	$ 20,731,004	$ (728,744)	$ 21,459,748
A02. Liabilities	14,035,948	(1,134,035)	15,169,983
A03. Surplus as regards to policyholders	6,695,056	(405,292)	7,100,348
A04. Income before taxes	191,568	(7,228)	198,796

(B) Summary of Reinsurance Contract Terms	(C) Management's Objectives
Refer to Note 9	The treaty was entered into in 2002 with the approval of the Department of Insurance to generate the needed surplus. The treaty also provided a limited aggregate loss development to cover for losses paid after December 31, 2001 on claims from the 1980 to 1998 accident years.

7. Has the reporting entity 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; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member where:

(a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (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 the reporting entity or its affiliates in a separate reinsurance contract. Yes [ ] No [X]

8. If yes to 6 or 7, please provide the following information:

   (a) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income;

   (b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 6 or 7; and

   (c) A brief discussion of management's principle objectives in entering into the reinsurance contract including the economic purpose to be achieved.

9. Except for transactions meeting the requirements of paragraph 31 of SSAP No. 62R, *Property and Casualty Reinsurance*, has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) 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? Yes [ ] No [X]

10. If yes to 9, explain why the contract(s) is treated differently for GAAP and SAP.

Note – Basis of Presentation

The accompanying supplementary information presents selected statutory-basis financial data as of December 31, 2016 and for the year then ended, for purposes of complying with the National Association of Insurance Commissioner's *Annual Statement Instructions and Accounting Practices and Procedures Manual* and agrees to, or is included in, the amounts reported in Company's 2016 Statutory Annual Statement as filed with the CDI.

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