



**STATE COMPENSATION INSURANCE FUND**

Statutory Basis Financial Statements

December 31, 2015 and 2014

(With Independent Auditors' Report Thereon)



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

## **Independent Auditors' Report**

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

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

We have audited the accompanying financial statements of State Compensation Insurance Fund, which comprise the statutory statements of admitted assets, liabilities, and policyholders' surplus as of December 31, 2015 and 2014, and the related statutory statements of operations and changes in policyholders' surplus, and cash flow for the years then ended, and the related notes to the statutory financial statements.

### ***Management's Responsibility for the Financial Statements***

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

### ***Auditors' Responsibility***

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

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

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



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

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

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

***Adverse Opinion on U.S. Generally Accepted Accounting Principles***

In our opinion, because of the significance of the variances between statutory accounting practices and U.S. generally accepted accounting principles discussed in the Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles paragraph, the financial statements referred to above do not present fairly, in accordance with U.S. generally accepted accounting principles, the financial position of State Compensation Insurance Fund as of December 31, 2015 and 2014, or the results of its operations or its cash flows for the years then ended.

***Opinion on Statutory Basis of Accounting***

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of State Compensation Insurance Fund as of December 31, 2015 and 2014, and the results of its operations and its cash flow for the years then ended, in accordance with statutory accounting practices prescribed or permitted by the California Department of Insurance described in note 2.

***Other Matter***

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The supplementary information included in the supplemental investment risk interrogatories (Schedule I), supplemental summary investment schedules (Schedule II), and supplemental reinsurance interrogatories (Schedule III) is presented for purposes of additional analysis and is not a required part of the financial statements but is supplementary information required by the California Department of Insurance. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

**KPMG LLP**

San Francisco, California  
May 26, 2016

## STATE COMPENSATION INSURANCE FUND

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

December 31, 2015 and 2014

(In thousands)

<b>Admitted Assets</b>	<b>2015</b>	<b>2014</b>
Bonds, at amortized cost	\$ 18,492,379	17,938,362
Common stocks	892,532	993,631
Real estate	247,847	253,469
Cash, cash equivalents, and short-term investments	61,805	76,408
Receivables for securities	701	245
Total cash and investments	19,695,264	19,262,115
Premiums in the course of collection	82,875	58,648
Earned but unbilled premiums	202,454	212,974
Reinsurance recoverables	13,974	1,615
Accrued interest and dividends	139,910	138,123
Guaranty fund receivables	26,176	16,982
Due from adjusting contracts	48,465	30,696
Other assets	20,278	19,883
Total admitted assets	\$ 20,229,396	19,741,036
<b>Liabilities and Policyholders' Surplus</b>		
Estimated liabilities for:		
Losses	\$ 10,945,630	10,687,180
Loss adjustment expenses	1,742,177	1,744,634
Retroactive reinsurance ceded	(414,464)	(465,889)
Unearned premiums	78,565	70,146
Dividends reserve	18,110	104,910
Other postemployment benefit liability	671,932	615,848
Borrowed money and interest thereon	172,574	97,129
Deposit liability	153,369	143,522
Self-insurance reserve	134,253	122,828
Other liabilities	187,811	245,562
Total liabilities	13,689,957	13,365,870
Special surplus funds for:		
Retroactive reinsurance	414,464	465,889
Unfunded pension and other postemployment benefits	1,654,124	905,724
Unassigned surplus	4,470,851	5,003,553
Policyholders' surplus	6,539,439	6,375,166
Total liabilities and policyholders' surplus	\$ 20,229,396	19,741,036

See accompanying notes to statutory basis financial statements.

## STATE COMPENSATION INSURANCE FUND

### Statements of Operations (Statutory Basis)

Years ended December 31, 2015 and 2014

(In thousands)

	<u>2015</u>	<u>2014</u>
Net premiums earned	\$ 1,604,612	1,668,709
Losses incurred	1,251,597	1,372,391
Loss adjustment expenses incurred	453,829	602,435
Underwriting and administrative expenses	<u>382,026</u>	<u>375,111</u>
Total underwriting deductions	<u>2,087,452</u>	<u>2,349,937</u>
Net underwriting loss	(482,840)	(681,228)
Net investment income earned	642,254	656,287
Net realized capital gains	89,123	75,377
Other loss	<u>(16,000)</u>	<u>(16,961)</u>
Net income before dividends to policyholders	232,537	33,475
Dividends to policyholders	<u>(38,321)</u>	<u>(3,719)</u>
Net income	<u>\$ 270,858</u>	<u>37,194</u>

See accompanying notes to statutory basis financial statements.

## STATE COMPENSATION INSURANCE FUND

### Statements of Changes in Policyholders' Surplus (Statutory Basis)

Years ended December 31, 2015 and 2014

(In thousands)

	<u>2015</u>	<u>2014</u>
Balance, January 1	\$ 6,375,166	6,353,460
Net income	270,858	37,194
Change in nonadmitted assets	(2,438)	(23,904)
Change in net unrealized capital gain	(65,143)	59,225
Unfunded actuarial accrued liability allocation	(38,600)	(51,689)
Change in provision for reinsurance	(404)	880
Balance, December 31	<u>\$ 6,539,439</u>	<u>6,375,166</u>

See accompanying notes to statutory basis financial statements.

## STATE COMPENSATION INSURANCE FUND

### Statements of Cash Flow (Statutory Basis)

Years ended December 31, 2015 and 2014

(In thousands)

	2015	2014
Cash from operations:		
Premiums collected net of reinsurance	\$ 1,561,513	1,469,095
Net investment income	714,919	719,035
Other income received	20,171	9,039
Benefits and loss-related payments	(1,005,506)	(1,187,551)
Other underwriting expenses	(892,130)	(823,808)
Net cash provided by operations	398,967	185,810
Cash from investments:		
Proceeds from investments sold, matured, or repaid:		
Bonds	2,420,893	2,648,578
Common stocks	442,190	293,646
Real estate	—	67,117
Change in receivable for securities	(457)	(53)
Cost of investments acquired:		
Bonds	(3,016,465)	(3,146,979)
Common stocks	(344,285)	(276,612)
Change in payable for securities	(44,564)	21,412
Net cash used in investing activities	(542,688)	(392,891)
Cash from financing and miscellaneous sources:		
Borrowed funds	75,445	(4)
Other cash provided	53,673	128,332
Net cash provided by financing and miscellaneous sources	129,118	128,328
Net change in cash, cash equivalents, and short-term investments	(14,603)	(78,753)
Cash, cash equivalents, and short-term investments, beginning of year	76,408	155,161
Cash, cash equivalents, and short-term investments, end of year	\$ 61,805	76,408
The Company reported the following noncash operating, investing, and financing activities (included as applicable) in 2015 and 2014:		
Depreciation	\$ 17,412	20,825
Special surplus funds (retroactive reinsurance, unfunded pension, and other postemployment benefit)	696,975	(90,799)
Premium charge-offs	36,170	25,999
Investments (amortization of premium, accrual of discount, unrealized gain/loss, and impairment)	(138,366)	5,562

See accompanying notes to statutory basis financial statements.

## STATE COMPENSATION INSURANCE FUND

Notes to Statutory Basis Financial Statements

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(Dollar amounts in thousands)

### (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. In accordance with the Code, the Board of Directors of State Fund is composed of eleven members, nine of whom shall be appointed by the Governor. The Speaker of the Assembly shall appoint one member 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 the workplaces safe, and restore injured workers. State Fund is self-supported with revenue from premiums written and from investment income. It does not receive any financial support from the State and the State is not liable for any obligations of State Fund.

### (2) Summary of Significant Accounting Policies

#### (a) Basis of Presentation

The statutory basis financial statements of State Fund have been prepared in conformity with accounting practices prescribed or permitted by the California Department of Insurance (CDI), and in accordance with the National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures Manual*, to the extent those practices and procedures do not conflict with the California Insurance Code. As a state official approves State Fund's governing board members, U.S. generally accepted accounting 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.

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

- The net amount of all cash accounts is reported jointly and in instances of a net negative cash balance, amounts are reported as a negative asset rather than liability.
- Investment in bonds and short-term investments are carried principally at amortized cost, whereas under GASB such investments would be carried at fair value with changes in fair value reflected in net income.
- Unrealized gains and losses on investments in common stocks are 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,



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

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

The preparation of financial statements in conformity with statutory accounting principles prescribed or permitted by the CDI requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. Actual results could differ materially from those estimates. Among the most

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significant estimates inherent in these statutory financial statements are the liabilities for losses and loss adjustment expenses (see note 2(f)), and State Fund's portion of the pension and other postemployment benefits (OPEB) costs estimated by State Fund based on the current actuarial valuation prepared for the State of California (see note 2(j)).

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

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

**(d) Investments**

Investments in bonds are valued in accordance with the requirements of the Securities Valuation Office (SVO) of the NAIC. Bonds are generally stated at amortized cost, except bonds that are defined by the NAIC as Class 3 through 6, which are stated at the lower of amortized cost or fair value. Amortization is calculated using the constant-yield method. Mortgage-backed securities (MBS) are amortized using anticipated prepayments and are accounted for using the prospective method. The carrying value for MBS has been determined in accordance with the guidelines of the NAIC. 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. Median Speeds is a model that serves as a benchmark for MBS prepayment assumptions. This model looks to the specifics of the security dealers' models. When median assumptions are used for analysis, the data provider will scan all of the median security dealers' prepayment assumptions and choose the speed in the middle.

Fair value for bonds is primarily determined using a pricing hierarchy starting with a widely accepted pricing vendor, followed by State Fund's custodial bank, portfolio managers' independent pricing services, and other pricing services. Fair value for common stock is primarily determined using a pricing hierarchy from a widely accepted pricing vendor.

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 MBS's, to the present value of expected cash flows if management has the ability and intent to hold the MBS to recovery of that amount 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 impairment is "other than temporary," State Fund considers many factors including credit quality, market analysis,

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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 of the interest-related impairment.

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/losses in the statement of operations. Unrealized gains and losses for assets carried at fair value are reflected in policyholders' surplus.

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

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

**(e) *Real Estate, Furniture, 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. 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

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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. There were no changes in the capitalization policy during 2015.

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

Management records its best estimate of the liabilities for losses and loss adjustment expenses (LAE). These liabilities include the estimated future cost of reported claims, the cost of claims incurred but not reported, and expenses related to investigating and settling claims. State Fund does not discount these liabilities. These liabilities are based on actuarial estimates that are subject to considerable uncertainty. Should State Fund's losses develop in the future differently from their historical loss development or those projected by the actuarial methods, actual losses would vary, perhaps significantly, from such actuarial estimates. Any adjustments to these estimates are reflected in operations when known (see note 8).

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

**(g) *Revenue Recognition and Unearned Premiums***

State Fund applies the "Western Accounting Method" in which direct written premium is recognized when billed to the policyholder. Insurance premiums are recognized as earned ratably over the term of

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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.

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. As of December 31, 2015 and 2014, State Fund has no liabilities related to premium deficiency reserves. State Fund considers anticipated investment income when determining the existence of a premium deficiency.

### **(h) Reinsurance**

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

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

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

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

### **(i) Guaranty Fund and Other Assessments**

In California, all insurers writing workers' compensation, including State Fund, are subject to assessment by the California Insurance Guarantee Association (CIGA) and the Department of Industrial Relations (DIR) to protect claimants against insurer insolvencies and administer various aspects of the workers' compensation system. The 2015 and 2014 annual CIGA assessment was 1.83% and 2.25%, respectively, of direct written premium. The DIR assessment aggregates to approximately 1.45% and 2.23% of direct written premium for 2015 and 2014, respectively. Annual assessments are paid in advance, based on prior year premiums with the final assessment based on reported calendar

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year written premium. Additional amounts owed are included in the guaranty fund assessments liability and the DIR assessments are included in other liabilities. Amounts prepaid in excess of the final assessment amount are available for credit against future assessments and included in guaranty fund receivables.

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

State Fund expects to fund CIGA for guaranty fund assessments for at least the next year at a rate of 2.00% of future direct premiums written. Based on information currently available, State Fund expects to continue to be obligated to fund CIGA annually, at rates that are determined and announced annually.

Under the U.S. Longshoremen's and Harbor Workers' (L&H) Compensation Act (the Act), all carriers and self-insurers writing U.S. L&H policies, including State Fund, are required to make payments into a Special Fund based on a pro rated assessment determined by the Secretary of the U.S. Department of Labor. The Special Fund was created to protect injured employees or their survivors by providing for subsequent injuries as defined by the Act. State Fund recorded a liability of \$10,503 and \$11,950 included in the "other liabilities" account as of December 31, 2015 and 2014, respectively, for future assessments under the Act.

#### **(j) Pension and Other Postemployment Benefit Plans**

State Fund employees are employees of the State of California (the State). Consequently, State Fund employees participate in the State pension and OPEB plans. State Fund is not directly liable for obligations under the plans. As a result, State Fund recognizes pension and OPEB expense equal to its allocation from the State of the pension and OPEB cost for the period.

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

The State's OPEB plan provides medical, prescription drug, and dental benefits (healthcare benefits) to retired statewide employees. The authority for establishing and amending the OPEB plan lies with CalPERS, while the authority for establishing and amending the funding policy lies with the State Legislature. The State's OPEB plan is a single-employer defined-benefit plan.

The State's annual OPEB cost is calculated based on the annual required contribution (ARC) of the employer, an amount actuarially determined by the State in accordance with the parameters of GASB No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (GASB 45). The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year (Normal Cost) and amortize any unfunded actuarial accrued

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liabilities (or funding excess) (UAAL) over a period not to exceed 30 years. The State determines the annual allocation for State Fund based upon the relationship of active employee health benefit costs for State Fund as compared to the total State active employee health benefit costs. State Fund has been recording its additional share (per GASB 45) of the annual OPEB cost since December 2008 and carries the accumulated balance (i.e., the allocated amount less the amount State Fund has funded to the State) as a liability. State Fund continues to pay on a “pay-as-you-go” funding policy.

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

The State’s 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. GASB No. 68, *Accounting and Financial Reporting for Pensions* (GASB 68), is effective for public employers’ fiscal year beginning after June 15, 2014. 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, 2015 (using a valuation date of June 30, 2014), including an allocation of State Fund’s proportionate share of the State’s net pension liability that State Fund is required to disclose. State Fund estimated the portion of the State’s unfunded Pension and OPEB liabilities attributable to State Fund as of December 31, 2015 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 State of California OPEB valuation report as of June 30, 2015, 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 of California. Under the pay-as-you-go funding scenario, the State is assumed to finance retiree healthcare benefits from assets available in the general fund. The State’s actuarial assumptions included a discount rate of 4.25%, and an annual healthcare cost trend rate of 8.00% in 2017 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 2015.

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State Fund established a special surplus account to provide for the portion of the contingency for OPEB and pension that has not already been accrued as a liability (Unfunded Actuarial Accrued Liability – UAAL), as permitted by SSAP No. 72, *Surplus and 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.

State Fund recognizes in the statement of operations only the annual Normal Cost allocation from the State, as this is the Company’s current year expense for the plan for the period, in accordance with statutory accounting for plans in which an insurer participates but is not directly liable. The annual UAAL allocation from the State is recorded 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. In anticipation of CalPERS future implementation of GASB 75, State Fund engaged a third party actuary to estimate State Fund’s proportionate share of net OPEB liability. The UAAL adjustment resulting from GASB No. 75 assessment is recorded as a direct addition to the special surplus account.

**(k) Income Taxes**

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

**(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, 2015 and 2014, policyholders’ surplus exceeded the minimum RBC requirements.

**(4) Investment Securities**

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



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**(a) Bonds**

The carrying value, gross unrealized gains and losses, and fair value of investments in bonds as of December 31, 2015 and 2014 are as follows:

	<b>2015</b>			
	<b>Carrying value</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>
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	\$ <u>18,492,379</u>	<u>595,813</u>	<u>(117,518)</u>	<u>18,970,674</u>
	<b>2014</b>			
	<b>Carrying value</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>
All other governments	\$ 211,645	10,407	(190)	221,862
Industrial and miscellaneous	6,495,132	248,255	(24,930)	6,718,457
Political subdivisions	306,833	37,861	(699)	343,995
Special revenue/assessment	2,608,681	227,774	(2,951)	2,833,504
States, territories, and possessions	266,162	37,966	(13)	304,115
U.S. government	1,015,655	71,948	(555)	1,087,048
Mortgage-backed securities:				
Special revenue/assessment	6,089,110	189,456	(17,457)	6,261,109
U.S. government	945,144	51,946	(8,398)	988,692
Total	\$ <u>17,938,362</u>	<u>875,613</u>	<u>(55,193)</u>	<u>18,758,782</u>

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The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2015 and 2014:

	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 subdivision	36,369	(317)	—	—	36,369	(317)
Special revenue/assessment States, Territories, and Possessions	354,633	(5,797)	—	—	354,633	(5,797)
U.S. government	19,936	(354)	—	—	19,936	(354)
Mortgage-backed securities: Special revenue/assessment U.S. government	39,518	(521)	—	—	39,518	(521)
	2,238,117	(27,068)	206,744	(7,781)	2,444,861	(34,849)
	85,414	(383)	82,665	(2,556)	168,079	(2,939)
Total	<u>\$ 5,936,026</u>	<u>(100,784)</u>	<u>393,317</u>	<u>(16,734)</u>	<u>6,329,343</u>	<u>(117,518)</u>

	2014					
	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	\$ 19,898	(87)	9,890	(103)	29,788	(190)
Industrial and miscellaneous	816,950	(5,612)	743,763	(19,318)	1,560,713	(24,930)
Political subdivision	23,316	(522)	11,021	(177)	34,337	(699)
Special revenue/assessment States, Territories, and Possessions	96,427	(1,298)	88,369	(1,653)	184,796	(2,951)
U.S. government	1,987	(13)	—	—	1,987	(13)
Mortgage-backed securities: Special revenue/assessment U.S. government	—	—	39,513	(555)	39,513	(555)
	371,549	(1,444)	903,697	(16,013)	1,275,246	(17,457)
	40,653	(230)	196,096	(8,168)	236,749	(8,398)
Total	<u>\$ 1,370,780</u>	<u>(9,206)</u>	<u>1,992,349</u>	<u>(45,987)</u>	<u>3,363,129</u>	<u>(55,193)</u>

As of December 31, 2015 and 2014, 517 and 359 securities were in an unrealized loss position, which resulted in an unrealized loss of \$117,518 and \$55,193, respectively. As of December 31, 2015 and 2014, the unrealized loss position was attributed to the increase in interest rates over the course of 2015 and 2014. This led to a downward price movement across all sectors in the bond portfolio, given the inverse relationship between interest rates and bond fair values. Global issues, notably that of China, also negatively affected the year-end fair values. State Fund's bond portfolio is primarily comprised of investment grade securities. As of December 31, 2015 and 2014, 96% and 98%, 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, 2015 and 2014 were temporary in nature.

The carrying value and fair value of bonds as of December 31, 2015, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have

**STATE COMPENSATION INSURANCE FUND**

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the right to call or prepay obligations with or without call or prepayment penalties. MBS provide for periodic payments through their lives so they are listed separately.

	<b>2015</b>	
	<b>Carrying value</b>	<b>Fair value</b>
Due in one year or less	\$ 974,243	988,450
Due after one year through five years	4,224,105	4,341,784
Due after five years through ten years	4,089,555	4,165,176
Due after ten years	2,229,943	2,367,594
Sum of amounts due from < 1 to >10 years	11,517,846	11,863,004
Mortgage-backed securities	6,974,533	7,107,670
Total	<u>\$ 18,492,379</u>	<u>18,970,674</u>

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

Proceeds from sales of bonds during 2014 were \$643,015 with gross realized gains of \$30,966 and gross realized losses of \$1,744.

State Fund recognized other-than-temporary impairment of \$575 and \$0 in bonds for the years ended December 31, 2015 and 2014, respectively.

State Fund had \$66,785 on deposit with the Federal Reserve Bank of St. Louis beginning May 2015 and \$66,881 on deposit with the Federal Reserve Bank of Philadelphia prior to the change to satisfy the U.S. Department of Labor regulations relating to State Fund's issuance of U.S. L&H policies as of December 31, 2015 and 2014, respectively.

**(b) Common Stocks**

The tables below reflect costs, gross unrealized gains and losses, and fair value of investments in common stocks as of December 31, 2015 and 2014:

	<b>2015</b>			
	<b>Cost</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>Fair value</b>
Industrial and miscellaneous	\$ 799,868	120,255	(27,591)	892,532
Total common stocks	<u>\$ 799,868</u>	<u>120,255</u>	<u>(27,591)</u>	<u>892,532</u>

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		<b>2014</b>			
		<u>Cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>
Industrial and miscellaneous	\$	835,824	166,820	(9,013)	993,631
Total common stocks	\$	<u>835,824</u>	<u>166,820</u>	<u>(9,013)</u>	<u>993,631</u>

The tables below reflect the summary of temporarily impaired common stocks as of December 31, 2015 and 2014:

		<b>2015</b>					
		<u>Less than 12 months</u>	<u>12 months or more</u>		<u>Total</u>		
		<u>Fair value</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>	<u>Gross unrealized losses</u>
Industrial and miscellaneous	\$	203,794	(22,232)	12,131	(5,359)	215,925	(27,591)
Total common stocks	\$	<u>203,794</u>	<u>(22,232)</u>	<u>12,131</u>	<u>(5,359)</u>	<u>215,925</u>	<u>(27,591)</u>

		<b>2014</b>					
		<u>Less than 12 months</u>	<u>12 months or more</u>		<u>Total</u>		
		<u>Fair value</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>	<u>Gross unrealized losses</u>
Industrial and miscellaneous	\$	112,158	(8,956)	430	(57)	112,588	(9,013)
Total common stocks	\$	<u>112,158</u>	<u>(8,956)</u>	<u>430</u>	<u>(57)</u>	<u>112,588</u>	<u>(9,013)</u>

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 not limited to, are 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 2015 were \$442,190 with gross realized gains of \$81,173 and gross realized losses of \$15,305. Proceeds from sales or disposals of common stocks during 2014 were \$293,646 with gross realized gains of \$39,735 and gross realized losses of \$5,623.

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State Fund recognized other-than-temporary impairment of \$3,919 and \$0 in common stocks for the years ended 2015 and 2014, respectively.

In 2013, State Fund purchased \$25,000 of FHLB common stock as an initial requirement to become a member of the FHLB of San Francisco. This Class B membership stock's current cost is \$17,250 due to capital stock redemption on May 15, 2015 of \$7,750. FHLB shares are valued at cost and not publicly traded.

(c) ***Structured Securities and Other***

State Fund does not engage in subprime residential mortgage lending nor does it invest directly in subprime fixed income securities. As of December 31, 2015 and 2014, State Fund has no direct subprime mortgage-related risk exposure. However, State Fund does invest primarily in MBS that are backed by government agencies or government-sponsored entities, specifically Ginnie Mae, Fannie Mae, and Freddie Mac. These types of securities are collateralized by loans but are ultimately backed by the issuing agency. Ginnie Mae securities are guaranteed by the U.S. Treasury. State Fund as well as other State Agencies and Local Agencies are authorized to invest funds in the State of California's Pooled Money Investment Account (PMIA). State Fund's holdings in the PMIA at December 31, 2015 and 2014 were \$26,982 and \$26,006, respectively.

The tables below summarize State Fund's Structured Notes as of December 31, 2015 and 2014:

Description	CUSIP identification	2015		Book/ adjusted carrying value
		Actual cost	Fair 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

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<u>Description</u>	<u>CUSIP identification</u>	<u>2014</u>		
		<u>Actual cost</u>	<u>Fair value</u>	<u>Book/ adjusted carrying value</u>
Bank of New York Mellon	064058AA8	\$ 5,093	5,146	5,081
Metlife Inc	59156RBK3	3,009	3,007	3,009
Wells Fargo & Company	949746QU8	5,915	6,096	5,884
Total		\$ <u>14,017</u>	<u>14,249</u>	<u>13,974</u>

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

	<u>2015</u>	<u>2014</u>
Bonds	\$ 635,647	654,884
Common stocks	25,805	24,220
Real estate	25,000	25,182
Other	126	88
Total investment income	686,578	704,374
Less investment expenses	(44,324)	(48,087)
Net investment income	\$ <u>642,254</u>	<u>656,287</u>

**(5) Fair Value Measurement**

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

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

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

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

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

		<b>December 31, 2015</b>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Financial assets:				
Bonds	\$	—	18,960,061	10,613
Common stocks		848,578	17,250	26,704
Cash, cash equivalents, and short-term investments		61,805	—	—
Receivables for securities		701	—	—
Total	\$	<u>911,084</u>	<u>18,977,311</u>	<u>37,317</u>
Financial liabilities:				
Borrowed money and interest thereon	\$	—	171,815	—
Payables for securities		351	—	—
Total	\$	<u>351</u>	<u>171,815</u>	<u>—</u>
		<b>December 31, 2014</b>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Financial assets:				
Bonds	\$	—	18,747,937	10,845
Common stocks		968,631	25,000	—
Cash, cash equivalents, and short-term investments		76,408	—	—
Receivables for securities		245	—	—
Total	\$	<u>1,045,284</u>	<u>18,772,937</u>	<u>10,845</u>
Financial liabilities:				
Borrowed money and interest thereon	\$	—	97,129	—
Payables for securities		44,916	—	—
Total	\$	<u>44,916</u>	<u>97,129</u>	<u>—</u>

### (6) Borrowed Money

State Fund has pledged to FHLB bonds 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 \$172,291 is subject to prepayment penalties.

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The table below summarizes the FHLB pledge and borrowing:

	<b>2015</b>	<b>2014</b>
Actual or estimated borrowing capacity as of reporting date	\$ 727,396	608,598
Collateral amount pledged as of reporting date:		
Fair value	\$ 986,934	736,983
Carrying value	938,511	695,431
Maximum collateral amount pledged during the reporting period:		
Fair value	\$ 1,036,720	878,003
Carrying value	968,302	818,522
Maximum amount borrowed during the reporting period	\$ 229,117	297,013
Borrowing from FHLB as of reporting date	\$ 172,291	97,013

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

<b>December 31, 2015</b>					
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

<b>December 31, 2014</b>					
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%	\$ 138
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	519
06/04/13	05/22/18	9,713	1.335	1.335	132
Total		\$ 97,013			\$ 905

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



## STATE COMPENSATION INSURANCE FUND

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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.

#### (7) Real Estate, Furniture, Equipment, and Leasehold Improvements

Real estate as of December 31, 2015 and 2014 is comprised of the following:

	<u>2015</u>	<u>2014</u>
Property occupied by the Company	\$ 312,117	312,117
Property held for sale	710	710
	<u>312,827</u>	<u>312,827</u>
Accumulated depreciation	<u>(64,980)</u>	<u>(59,358)</u>
Total	<u>\$ 247,847</u>	<u>253,469</u>

Depreciation expense on real estate was \$5,622 for the years ended December 31, 2015 and 2014. State Fund did not sell any real estate properties in 2015. State Fund realized a net capital gain of \$6,967 on sale of real estate properties in 2014. As of December 31, 2015 and 2014, State Fund did not impair real estate property held for sale.

Furniture, equipment, and leasehold improvements as of December 31, 2015 and 2014 comprise the following:

	<u>2015</u>	<u>2014</u>
Data processing equipment and software	\$ 307,893	297,443
Office furniture, equipment, and leasehold improvements	54,568	52,642
	<u>362,461</u>	<u>350,085</u>
Accumulated depreciation	<u>(343,296)</u>	<u>(331,470)</u>
	19,165	18,615
Nonadmitted assets	<u>(8,918)</u>	<u>(12,799)</u>
Total	<u>\$ 10,247</u>	<u>5,816</u>

Depreciation and amortization expenses on furniture, equipment, and leasehold improvements were \$11,827 and \$15,203 for the years ended December 31, 2015 and 2014, respectively.

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**(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, 2015 and 2014. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of a loss portfolio transfer.

	<u>2015</u>	<u>2014</u>
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of \$67,208 and \$101,570, respectively	\$ 12,431,814	12,101,049
Add incurred related to:		
Current year	1,700,408	1,709,414
Prior years	<u>5,018</u>	<u>265,412</u>
Total incurred	<u>1,705,426</u>	<u>1,974,826</u>
Less paid related to:		
Current year	256,816	188,346
Prior years	<u>1,192,617</u>	<u>1,455,715</u>
Total paid	<u>1,449,433</u>	<u>1,644,061</u>
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of \$49,548 and \$67,208, respectively	<u>\$ 12,687,807</u>	<u>12,431,814</u>

Incurred losses and loss adjustment expenses relating to insured events in prior years were approximately \$5,018 and \$265,412 in 2015 and 2014, respectively. The unfavorable 2015 incurred related to prior year is primarily attributed to the reserves strengthening of \$5 million for LAE due to increased administrative costs. The unfavorable 2014 incurred related to prior year is primarily attributed to the reserves strengthening of \$100 million for Loss and \$165 million for LAE to recognize uncertainty in pre-2000 accident years, increased medical cost containment expenses due to post reform independent medical review costs, and increased administrative costs.

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 (SB863 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 \$34,298 and \$36,716 as of December 31, 2015 and 2014, respectively.

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(Dollar amounts in thousands)

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 in 2013 and 2014. One benefit may be greater diversification of the book of business as new business with a better loss profile is attracted through the new pricing structure. Over time, this risk should diminish as the pricing tier structure matures.

Also, in November 2003, the California Legislature passed Assembly Bill 227 and Senate Bill 228, representing a major reform of the workers' compensation system. This was followed in April 2004 by the further reforms of Senate Bill 899. These bills provide for major changes in benefit levels and the administration of claims, impacting both new claims and open claims from earlier accident years. Management has considered the impact of these reforms in estimating future liabilities; however, the breadth of the changes and their impact on loss development patterns, and the potential for future legislative, regulatory, or judicial decisions to retroactively impact currently estimated liabilities add a level of uncertainty to a current estimate of future liabilities. In August 2012, Senate Bill 863 (SB 863) was passed. The bill makes wide-ranging changes to California's workers' compensation system, including increased benefits to injured workers and cost-saving efficiencies. The bill became effective January 1, 2013. The full impact of SB 863 on incurred and unpaid claims is uncertain. In March 2010, the Affordable Care Act of 2010 (Affordable Care Act), was signed into law. The Affordable Care Act may impact healthcare costs and delivery. Since healthcare is the largest component of State Fund's loss costs, this legislation may impact State Fund, although the impact, if any, is uncertain.

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

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

As a workers' compensation carrier, State Fund has incidental exposure to asbestos and environmental claims. Given that State Fund's book is principally small to medium size businesses, State Fund has no significant asbestos and environmental exposure aggregations. Asbestos and environmental claims are handled in the routine course of business. Claims are made up on a per claimant basis.

**STATE COMPENSATION INSURANCE FUND**

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(Dollar amounts in thousands)

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

	<u>2015</u>	<u>2014</u>
(1) Asbestos, direct:		
a. Beginning reserves (including case, bulk and IBNR, and LAE)	\$ 45,403	48,067
b. Losses and LAE incurred	—	—
c. Calendar year payments for losses and LAE	<u>(2,391)</u>	<u>(2,664)</u>
d. Ending reserves (including case, bulk and IBNR, and LAE)	\$ <u>43,012</u>	<u>45,403</u>
(2) Asbestos, assumed	\$ —	—
(3) Asbestos, net:		
a. Beginning reserves (including case, bulk and IBNR, and LAE)	\$ 41,403	44,067
b. Incurred losses and loss adjustment expenses	—	—
c. Calendar year payments for losses and LAE	<u>(2,134)</u>	<u>(2,664)</u>
d. Ending reserves (including case, bulk and IBNR, and LAE)	\$ <u>39,269</u>	<u>41,403</u>

State Fund requires the insurance companies that underwrite structured settlement annuities to have an A.M. Best credit rating of A+ or better and \$8 billion dollars or more in total assets at the time of purchase. The present value of purchased annuities as reported to State Fund by the issuers was \$903,348 and \$889,569 at December 31, 2015 and 2014. This represents the discounted amount as the nominal amount is not currently readily available from the issuers. 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,

**STATE COMPENSATION INSURANCE FUND**

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(Dollar amounts in thousands)

2015 and 2014, State Fund has reported ceded reinsurance balances (prior to the Loss Portfolio Transfer – LPT see note 9(c) for disclosure on LPT) as follows:

	2015	2014
Reinsurance ceded:		
Premium written	\$ 15,415	18,090
Premium earned	15,415	18,090
Premium (receivable) payable	(984)	—
Loss and loss adjustment expense incurred	13,548	(3,225)
Loss and loss adjustment expense reserve	49,548	67,208

Ceded loss and loss adjustment expense reserves include \$38,126 and \$42,248 recoverable from Reliastar Life Insurance Company as of December 31, 2015 and 2014. State Fund remains liable for amounts ceded in the event that reinsurers are unable to honor their obligations.

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

**(a) Catastrophic Reinsurance**

State Fund’s underwriting risk exposure is concentrated in California. As such, State Fund is exposed to earthquakes, terrorist acts, and other catastrophic events. These have not had significant adverse effects on operations in the past, but could present risks in the future. State Fund purchases reinsurance protection to 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 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. In 2014, State Fund was covered by per occurrence excess of loss reinsurance for \$300 million of losses in excess of \$300 million for a catastrophe involving at least 20 claimants. The treaties provided for one reinstatement to the full original limit, for an additional premium calculated as a pro rata share of the original premium, based on the portion of each layer being reinstated.

## STATE COMPENSATION INSURANCE FUND

### Notes to Statutory Basis Financial Statements

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(Dollar amounts in thousands)

State Fund was also covered in 2015 and 2014 by a multiyear catastrophe bond issued by special purpose reinsurer that would provide up to \$250 and \$200 million, respectively, 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 be held in trust to collateralize the agreement with State Fund and in the event of claim, State Fund can draw on the collateral. This catastrophe bond had the potential to cover losses for earthquakes with a magnitude greater than or equal to Mw 5.5 for the period from December 9, 2011 until December 31, 2014. A new catastrophe bond effective September 17, 2014 extends the period through December 31, 2018.

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 Terrorism Risk Insurance Program Reauthorization Act of 2015 (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.

For terrorism incidents in 2014, 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 2007 (TRIPRA). A private per occurrence excess of loss reinsurance treaty covered \$125 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 2013 Direct Earned Premium, or approximately \$222 million, subject to a statutorily industry-wide maximum.

**(b) Commutation**

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		<u>1,110</u>
Total	\$	<u><u>1,106</u></u>

For the year ended December 31, 2014, State Fund commuted reinsurance recoverable on unpaid losses and loss adjustment expenses of \$29,088, which included \$28,707 of losses incurred and \$381 of loss adjustment expenses, from the reinsurers listed below. State Fund's commutation settlement

## STATE COMPENSATION INSURANCE FUND

### Notes to Statutory Basis Financial Statements

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proceeds, net of reinsurance recoverable, on paid losses and loss adjustment expenses was \$33,156. The net effect of the commutation was a decrease in losses and loss adjustment expenses of \$4,068.

Clearwater Insurance Company	\$	(41)
Munich Re		(4,182)
Connecticut General Life Insurance Co		155
Total	\$	<u>(4,068)</u>

(c) ***Loss Portfolio Transfer (LPT)***

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

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

By December 31, 2005, State Fund's carried gross loss reserves for the subject losses exceeded the upper limit of the second layer of the treaty. State Fund increased retroactive ceded reserves by an additional \$270,000 (the \$300,000 in the second layer less State Fund's 10% retention). As a result, State Fund recognized an additional retroactive gain of \$256,500 (\$270,000 net of a \$13,500 deposit with Reinsurers for the coverage). Special surplus for retroactive reinsurance increased from \$319,800 in 2004 to \$576,300 at year-end of 2005. The special surplus for retroactive reinsurance 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 \$51,425 in 2015 and \$39,110 in 2014 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

## STATE COMPENSATION INSURANCE FUND

### Notes to Statutory Basis Financial Statements

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Payments (defined as individual payments exceeding \$10,000 intended to settle future liability) exceeds tabled values in the treaty (as specified at successive year-ends), this would void coverage on claims with subsequent Large Payments unless the Reinsurers provide prior written consent for the payments, or State Fund agreed that reimbursement would be apportioned over the life expectancy of the injured employee.

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

As of December 31, 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. As of December 31, 2014, cumulative subject paid losses were \$2,141,763, 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 \$839,111 was collected from the Reinsurers, \$68,526 was billed as a current receivable, and \$127,363 was receivable but not yet due from deferred large loss settlements.

As a result of a dispute arising in late 2012, as of December 31, 2014, an additional approximately \$68,000 in billed losses remained unpaid. State Fund believes the amount of total recoveries under this contract is not in question; however, the timing of the payments that are to be included in current billings to XL Re Ltd is being debated. The outcome of these proceedings could not be predicted as of December 31, 2014; however, the dispute was settled in 2015 and did not have an impact to the ultimate amount of coverage provided by the contract, nor a material dollar impact as regards the timing of receipt of recoveries under the contract.

#### (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, 2015 were as follows:

Year:		
2016	\$	13,676
2017		12,473
2018		12,202
2019		12,185
2020		12,156
Future years		<u>45,247</u>
Total	\$	<u><u>107,939</u></u>



**STATE COMPENSATION INSURANCE FUND**

Notes to Statutory Basis Financial Statements

December 31, 2015 and 2014

(Dollar amounts in thousands)

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, 2015 and 2014, the total rental expense for office space was \$32,346 and \$32,990, respectively, which is comprised of an allocation of rental value to space owned and occupied by State Fund of \$20,282 and \$20,541, and expense for leased properties of \$12,064 and \$12,449, respectively. Other lease expenses were \$980 and \$4,658 for the years ended December 31, 2015 and 2014, respectively.

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

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

State Fund incurred pension expense of \$66,719 and \$59,092 for the years ended December 31, 2015 and 2014, respectively.

State Fund paid retiree health benefit pro rata assessments of \$18,609 and \$24,614 for the years ended December 31, 2015 and 2014, respectively. The following table shows the components of State Fund’s allocation of the State’s 2015 and 2014 Annual Required Contribution (ARC), OPEB cost, the amount credited to the plan, and changes in the net OPEB obligation as of December 31, 2015 and 2014:

	<u>2015</u>	<u>2014</u>
Annual required contribution	\$ 91,414	97,887
Adjustment to annual required contribution	<u>(16,721)</u>	<u>2,066</u>
Annual OPEB cost	74,693	99,953
Estimated contribution credit	<u>(18,609)</u>	<u>(24,614)</u>
Increase in net OPEB obligation	56,084	75,339
Net OPEB obligation beginning of year	<u>615,848</u>	<u>540,509</u>
Net OPEB obligation end of year	\$ <u><u>671,932</u></u>	\$ <u><u>615,848</u></u>

The percentage of annual OPEB costs contributed to the plan was 25% for 2015 and 2014.

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 significant increase of State’s UAAL as a whole and a selection of more reasonable 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.

In 2014, based on the actuarial assessment of the State’s unfunded liabilities as of June 30, 2014, and the emergence pattern of State Fund’s share in terms of payroll and headcount as a percentage of those of the State as of December 31, 2014, State Fund’s estimated share of unfunded OPEB and pension is within the

## STATE COMPENSATION INSURANCE FUND

### Notes to Statutory Basis Financial Statements

December 31, 2015 and 2014

(Dollar amounts in thousands)

range of \$1-2 billion and State Fund recorded the midpoint of the range, or \$1.5 billion, as the estimated unfunded amount.

As discussed in note 2, State Fund established a special surplus account to provide for the portion of the contingency for OPEB and pension that has not already been accrued as a liability. As of December 31, 2015 and 2014, the portion of the unfunded OPEB contingency accrued as a liability is \$671,932 and \$615,848, respectively. As of December 31, 2015 and 2014, the special surplus for unfunded pension and OPEB is \$1,654,124 and \$905,724, respectively.

State Fund's annual OPEB cost is based on the ARC as determined by the State of California, which comprises Normal Cost and amortization of the unfunded actuarial liabilities from prior years (catch-up adjustments), as required by GASB. State Fund estimates the ARC as of December 31 of each calendar year based on the latest available Actuarial Valuation Report, which is as of June 30 of the same calendar year, and its share of the State's OPEB cost. State Fund recognizes the Normal Cost as expense in the statements of operations and policyholders' surplus, and reduces the special surplus account for the amortization of the catch-up adjustment based on the allocation ratio between Normal Cost and UAAL. In 2015, State Fund recorded OPEB expenses of \$36,093 and reduced special surplus by \$38,600. In 2014, State Fund recorded OPEB expenses of \$48,264 and reduced special surplus by \$51,689.

#### **(12) Policyholders' Dividends**

State Fund did not declare any dividends for year 2015 and declared \$37,000 in dividends for year 2014. The qualifying policyholders will receive 2.6% of estimated annual premium for the 2014 policy year.

#### **(13) Risks and Uncertainties**

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

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 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 COMPENSATION INSURANCE FUND**

Notes to Statutory Basis Financial Statements

December 31, 2015 and 2014

(Dollar amounts in thousands)

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(j) for discussion of the risks and uncertainties regarding estimates of contingent obligations for unfunded pension and OPEB.

**(14) Related Parties**

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

**(15) Special Surplus Funds**

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

	<u>Retroactive reinsurance</u>	<u>Unfunded pension and OPEB</u>
Balance at December 31, 2014	\$ 465,889	905,724
Transfer from recoveries under LPT	(51,425)	—
Transfer to OPEB liability	—	(38,600)
Transfer from unassigned surplus (note 11)	—	787,000
Balance at December 31, 2015	<u>\$ 414,464</u>	<u>1,654,124</u>

The following summarizes changes in the balances of special surplus funds for 2014:

	<u>Retroactive reinsurance</u>	<u>Unfunded pension and OPEB</u>
Balance at December 31, 2013	\$ 504,999	957,413
Transfer from recoveries under LPT	(39,110)	—
Transfer to OPEB liability	—	(51,689)
Balance at December 31, 2014	<u>\$ 465,889</u>	<u>905,724</u>

**STATE COMPENSATION INSURANCE FUND**

Notes to Statutory Basis Financial Statements

December 31, 2015 and 2014

(Dollar amounts in thousands)

**(16) Subsequent Events**

Management of State Fund has evaluated all events occurring after December 31, 2015 through May 26, 2016, the date the financial statements were available to be issued, to determine whether any events required either recognition or disclosure in the financial statements, noting no such events other than items already disclosed in the financial statements.

## STATE COMPENSATION INSURANCE FUND

## Supplemental Investment Risk Interrogatories

December 31, 2015

(Dollar amounts in thousands)

State Fund's total admitted assets as filed in the 2015 Annual Statement is: \$ 20,229,396

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	\$ 233,468	1.2%
Wells Fargo & Company	Industrial and miscellaneous	209,457	1.0
The Goldman Sachs Group, Inc.	Industrial and miscellaneous	158,360	0.8
Merck Sharp & Dohme Corp.	Industrial and miscellaneous	154,963	0.8
PepsiCo, Inc.	Industrial and miscellaneous	154,457	0.8
Occidental Petroleum Corporation	Industrial and miscellaneous	134,142	0.7
The Coca-Cola Company	Industrial and miscellaneous	130,062	0.6
Duke Energy Corporation	Industrial and miscellaneous	126,007	0.6
Chevron Corporation	Industrial and miscellaneous	123,626	0.6
Emerson Electric Co.	Industrial and miscellaneous	120,978	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	\$ 17,778,178	87.9%
NAIC – 2	714,201	3.5
NAIC – 3	—	—
NAIC – 4	—	—
NAIC – 5	—	—
NAIC – 6	—	—

State Fund does not have any preferred stocks.

State Fund does not hold any foreign investments.

State Fund's Canadian investments is less than 2.5% of the total admitted assets.

State Fund's real estate is less than 2.5% of the total admitted assets.

See accompanying independent auditors' report.

## STATE COMPENSATION INSURANCE FUND

## Supplemental Summary Investment Schedules

December 31, 2015

(Dollar amounts in thousands)

State Fund had the following invested assets as of December 31, 2015:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Bonds:				
U.S. Treasury securities	\$ 754,604	3.8%	\$ 754,604	3.8%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	31,646	0.2	31,646	0.2
Issued by U.S. government-sponsored agencies	766,657	3.9	766,657	3.9
Non-U.S. government (including Canada, excluding mortgage-backed securities)	193,952	1.0	193,952	1.0
Securities issued by states, territories, and possessions, and political subdivisions in the United States:				
States, territories, and possessions general obligations	269,598	1.4	269,598	1.4
Political subdivisions of states, territories, and possessions and political subdivisions general obligations	299,182	1.5	299,182	1.5
Revenue and assessment obligations	1,767,663	8.9	1,767,663	8.9
Industrial development and similar obligations	32,850	0.2	32,850	0.2
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	366,305	1.9	366,305	1.9
Issued or guaranteed by FNMA and FHLMC	4,801,186	24.3	4,801,186	24.3
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	1,804,976	9.2	1,804,976	9.2
All other	2,066	—	2,066	—
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	6,560,849	33.3	6,560,849	33.3
Unaffiliated non-U.S. securities (including Canada)	840,845	4.3	840,845	4.3
Equity interest:				
Unaffiliated publicly traded equity securities (excluding preferred stocks)	848,578	4.3	848,578	4.3
Unaffiliated other equity securities	43,954	0.2	43,954	0.2
Real estate investments:				
Property occupied by company	247,137	1.3	247,137	1.3
Property held for sale	710	—	710	—
Receivable for securities	701	—	701	—
Cash, cash equivalents, and short-term investments	61,805	0.3	61,805	0.3
Total cash and investments	\$ 19,695,264	100.0%	\$ 19,695,264	100.0%

See accompanying independent auditors' report.

**STATE COMPENSATION INSURANCE FUND**

Supplemental Reinsurance Interrogatories

December 31, 2015

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.

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

**STATE COMPENSATION INSURANCE FUND**

Supplemental Reinsurance Interrogatories

December 31, 2015

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.
- (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.