STATE COMPENSATION INSURANCE FUND

ANNUAL REPORT 2003

A MESSAGE FROM THE PRESIDENT

2003 marked an important turning point for California's workers' compensation system and for the State Compensation Insurance Fund. During 2003, the State Legislature enacted a series of important workers' compensation reform measures. The year also witnessed the election of a new governor, who in concert with the legislature returned to the subject of workers' compensation reform. The sense of urgency was palpable and the teamwork of the Governor and the State Legislature resulted in a new package of reform legislation, which was signed into law on April 19, 2004. The continuing cost pressures on employers was halted and the decline in workers' compensation premiums began.

DIANNE C. OKI, PRESIDENT

During 2003, and continuing this year, the men and women of State Fund worked tirelessly to implement the many reform measures. Immediately after the 2003 reform legislation AB 227 and SB 228 were passed, State Fund established a statewide "Reform Implementation Team" to ensure that we complied with and implemented the complex legislation. Classroom training was provided to more than 2,000 claims professionals and our legal staff throughout the state. This extraordinary training assured a smooth transition to the new laws and procedures. We also worked on the financial challenges placed before us as a result of our unprecedented growth. These challenges were formidable, and by the end of the year we achieved many of the goals we had set for ourselves. We moved aggressively to take advantage of cost saving opportunities. Our successful efforts have been underscored by the fact that for the first time in years, we were able to decrease rates as accounts renewed in 2004. In short, we achieved important financial goals and turned an important corner on rate relief.

At year's end, State Fund's total assets were $15.287 billion (including long term investments of $12.639 billion). We had total liabilities of $13.201 billion and a policyholder surplus of $2.086 billion.

Other 2003 financial highlights included: earned premium of $7.633 billion; investment earnings of $689 million; and net income totaling $712 million.

You will note that our 2003 audited financial statements do not show the comparative results for 2002. During 2003 State Fund changed auditors and appointed KPMG to perform the task. KPMG is internationally recognized for its expertise in the audit of insurance companies. Our 2003 financials, therefore, only show those years for which KPMG has issued an audit opinion. (The 2002 results containing the previous auditors report can be viewed elsewhere on our website through calendar year 2004.)

I am very pleased that our reserves were deemed reasonable and that State Fund is on a sound financial footing. However, an unstable marketplace combined with our recent growth dictates we continue to focus on building our surplus in order to reach industry recommended norms.

The work of the Governor and the State Legislature cannot be underestimated. Thanks to their efforts, there are signs that the marketplace is slowly returning to health and private carriers are considering re-entering the marketplace. Competition in the California workers' compensation marketplace will benefit employers, injured employees and State Fund. What is important to note is that the cycle of ever-increasing premium costs has been broken. What had been a record of consistent premium increases is on its way to becoming a cycle of premium decreases. The reform measures were hard fought and practical. They were not magic. Just as unsound pricing drove many of our competitors into bankruptcy during the end of the decade, less than cautious pricing now would have the exact same results. Employers needed and still need rate relief. That has begun, and I think it's clear that it will continue.

I can also assure you that State Fund will continue to fulfill its mission to serve the employers of California and their injured employees. The successful attainment of our mission is not always easy. But, it's what we do. It's what we believe in. With more than 90 years of on-the-job experience and a dedicated staff of employees who have spent their careers specializing in workers' compensation insurance, we are well positioned to continue our efforts to contribute to the return of a productive, viable and healthy workers' compensation environment. That's our commitment to you and we will work hard to achieve it.

Dianne C. Oki

DIANNE C. OKI, PRESIDENT

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For several decades, State Fund has produced hard copy editions of our annual report. This year we have joined an increasing number of organizations by presenting our annual financial statement exclusively on our website. This permits us to present this information at considerable cost savings.

FINANCIAL HIGHLIGHTS

December 31, 2003 and 2002—Dollar amounts in thousands

	2003	2002	Percent change
Assets	$15,287,008	$11,623,496	31.52%
Premiums Earned	7,633,200	5,359,292	42.43
Net Investment Income	689,764	572,688	20.44
Compensation & Medical Benefits	5,532,996	4,735,229	16.85
Claim Expenses	836,742	538,319	55.44
Net Income	712,558	25,958	2,645.04
Policyholders' Surplus	2,085,877	1,449,361	43.92
Policyholder Dividends Paid	5,763	95,065	(93.94)
Premiums Earned to Policyholders' Surplus Ratio	3.6594679	3.6976930	

See accompanying notes to statutory basis financial statements.

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors of
State Compensation Insurance Fund:

We have audited the accompanying statement of admitted assets, liabilities and policyholders' surplus (statutory basis) of the State Compensation Insurance Fund (State Fund) as of December 31, 2003 and the related statement of operations and changes in policyholders' surplus (statutory basis), and cash flows (statutory basis) for the year then ended. These financial statements are the responsibility of the State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described more fully in note 1 to the financial statements, the State Fund prepared these financial statements using accounting practices prescribed or permitted by the Department of Insurance of the State of California (CDI), which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between the statutory accounting practices and accounting principles generally accepted in the Unites States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of State Compensation Insurance Fund as of and for the year ended December 31, 2003.

As discussed in note 2 to the financial statements, State Fund's previous auditors issued an adverse opinion on the 2002 statutory basis financial statements based on their opinion that estimated liabilities for loss and loss adjustment expenses were understated and policyholders' surplus was, therefore, overstated by $1 billion. Accordingly, had State Fund recorded additional liabilities for loss and loss adjustment expenses in 2002, losses incurred would have decreased and net income would have increased in 2003.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statement of operations and changes in policyholders' surplus (statutory basis) does not present fairly the results of its operations for the year ended December 31, 2003 on the basis of accounting described in note 1.

REPORT OF INDEPENDENT AUDITORS, CONTINUED

In our opinion, the statement of admitted assets, liabilities and policyholders' surplus (statutory basis) and statement of cash flow (statutory basis) referred to above presents fairly, in all material respects, the admitted assets, liabilities and policyholders' surplus of State Compensation Insurance Fund as of December 31, 2003 and its cash flows for the year ended December 31, 2003 on the basis of accounting described in note 1.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included on supplemental schedules I and II is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

May 3, 2004

STATEMENT OF ADMITTED ASSETS, LIABILITIES AND POLICYHOLDERS' SURPLUS (STATUTORY BASIS)

December 31, 2003—Dollar amounts in thousands

Admitted Assets	
Bonds, at amortized cost	$12,639,034
Money market fund	472,708
Real estate	170,336
Short-term investments	50,262
Collateral for loaned securities	632,875
Cash	470,169
Total cash and investments	14,435,384
Premiums in the course of collection	151,000
Earned but unbilled premium	261,041
Reinsurance receivable	4,722
Accrued interest and dividends	136,514
Guarantee fund recoupments	128,890
Due from adjusting contracts	61,209
Data processing equipment, at cost less accumulated depreciation	43,454
Other assets	64,794
Total admitted assets	$15,287,008
Liabilities and Policyholders' Surplus	
Estimated liabilities for:	
Losses	$11,619,870
Loss adjustment expenses	1,187,801
Retroactive reinsurance ceded	(1,035,000)
Collateral for loaned securities	632,715
Unearned premiums	298,812
Reinsurance premiums payable	82,198
Dividends declared and unpaid	7,200
Guarantee fund assessments liability	86,788
Amounts held in trust	78,716
Other liabilities	242,031
Total liabilities	13,201,131
Special surplus for retroactive reinsurance	319,756
Unassigned surplus	1,766,121
Policyholders' surplus	2,085,877
Total liabilities and policyholders' surplus	$15,287,008

See accompanying notes to statutory basis financial statements.

STATEMENT OF OPERATIONS AND CHANGES IN POLICYHOLDERS' SURPLUS (STATUTORY BASIS)

Year ended December 31, 2003—Dollar amounts in thousands

Net premiums earned	$7,633,200
Losses incurred	5,532,996
Loss expenses incurred	836,742
Underwriting and administrative expenses	1,188,079
Total underwriting deductions	7,557,817
Net underwriting income	75,383
Investment income	567,360
Net realized capital gains	153,136
Investment expenses	(30,732)
Net investment income	689,764
Loss on premium charge-offs	(52,589)
Net income, before policyholders' dividends	712,558
Dividends to policyholders	163
Net income	712,395
Policyholders' surplus, beginning of year	1,449,361
Change in nonadmitted assets	(60,100)
Change in unrealized gains and losses	263
Change in provision for reinsurance	(16,042)
Policyholders' surplus, end of year	$2,085,877

See accompanying notes to statutory basis financial statements.

STATEMENTS OF CASH FLOWS (STATUTORY BASIS)

Year ended December 31, 2003—Dollar amounts in thousands

Premiums collected net of reinsurance	$7,578,629
Net investment income	542,730
Other expense	(52,589)
Benefits and loss related payments	(2,912,078)
Other underwriting expense	(1,697,917)
Dividends paid to policyholders	(5,763)
Net cash provided by operations	3,453,012
Proceeds from investments sold, matured, or repaid:	
Bonds	3,678,677
Money market fund	8,061,092
Collateral for loaned securities	—
Other	2,575
Cost of investments acquired:	
Bonds	(7,301,878)
Money market fund	(7,696,084)
Other	(51,141)
Net cash from investments	(3,306,759)
Other cash applied	(103,326)
Net cash from financing	(103,326)
Net change in cash and short-term investment	42,927
Cash, short-term investments and cash collateral for loaned securities, beginning of year	1,110,379
Cash, short-term investments and cash collateral for loaned securities, end of year	$1,153,306

See accompanying notes to statutory basis financial statements.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)

December 31, 2003—Dollar amounts in thousands

1. Summary of Significant Accounting Policies

A. History and Business

State Compensation Insurance Fund (State Fund) is a public enterprise fund established by the State of California through legislation enacted in 1913 to provide an available market for workers' compensation insurance to employers located in California. The State of California is not liable for any obligations of the State Fund. As a result of recent market conditions, the State Fund's market share currently exceeds 50% of all workers' compensation insurance written in the State of California (see note 2).

State Fund is vulnerable to catastrophes, such as earthquakes and terrorist acts, which have not had a significant adverse effect on operations in the past but represent risks in the future. State Fund purchases reinsurance protection, as more fully described in note 7, to mitigate losses from catastrophic events.

B. Basis of Presentation

The statutory basis financial statements of State Fund have been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of California (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. California Insurance Code Section 11558 requires companies to maintain a prescribed minimum reserve of loss and loss adjustment expenses for certain liability coverages, including workers' compensation insurance. This requirement differs from NAIC statutory practices, which do not have such a minimum reserve requirement. This difference between the CDI and NAIC does not impact statutory surplus at December 31, 2003 since carried loss and loss adjustment expense reserves exceed the minimum prescribed requirement.

These practices differ in certain respects from accounting principles generally accepted in the United States of America, as prescribed by the Governmental Accounting Standards Board (GASB). The significant differences from GASB are as follows:

- Investment securities are carried principally at amortized cost whereas under GASB such securities would be carried at estimated market value with changes in market value reflected in net income.
- Policy acquisition costs, including premium taxes, are charged to current operations as incurred, whereas related premium income is recognized on a pro rata basis over the periods covered by the policies. Under GASB, policy acquisition costs would be deferred and amortized to income on the same basis as premium income is recognized.
- Certain assets designated as "nonadmitted assets" are excluded from total assets. These assets consist principally of premiums in the course of collection outstanding over ninety days, 10% of earned but unbilled premiums (EBUB) in excess of collateral specifically held and identifiable, office furniture and equipment and prepaid expenses, the change in which is credited or charged directly to policyholders' surplus. Under GASB, these assets would be included in total assets.
- The gain upon entering into a retroactive reinsurance contract is recognized in income and established as segregated surplus. GASB requires the gain to be deferred and recognized over the estimated settlement period of the reinsured losses using either a recovery or interest method.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

- Policyholders' dividends are accrued when declared whereas under GASB they are accrued based on amounts ultimately to be paid.
- Fees received for processing the claims of other self-insured State of California departments are netted in loss and loss adjustment expenses, instead of being presented gross in conformity with GASB.
- Self rent is excluded from income and expense under GASB.
- The statement of cash flows differs in certain respects from the presentation required by GASB, including the presentation of the changes in cash, short-term investments, and collateral for loaned securities 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 these would be under GASB.

C. Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with statutory accounting principles permitted or prescribed by the CDI requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates inherent in these statutory financial statements are the liabilities for losses and loss adjustment expenses. Actual results could differ materially from those estimates.

D. Investments

Investments are valued in accordance with the requirements of the Securities Valuation Office of the NAIC. Short-term investments and investments in money market funds are carried at cost, which approximates market. Bonds are principally carried at amortized cost using the scientific (constant yield) interest method. Loaned-backed securities are amortized using anticipated prepayments and are accounted for using the prospective method. Prepayment assumptions for loan-backed securities are obtained from various external sources.

The aggregate market value of fixed income securities is determined from independent quotations obtained from the NAIC and independent pricing sources. Realized gains or losses on sale or maturity of investments are determined on the basis of specific identification and are included in net income.

Below investment grade bonds are carried at the lower of cost or market. Declines in the value of investments that are determined to be other than temporary, result in a reduction in carrying amount to fair value. The impairment charge is included as a realized loss and a new cost basis for the security is established. To determine whether an impairment is "other than temporary," State Fund considers credit quality, market analysis, current events, and management's judgment.

Loaned securities are recorded at cost and are included in the total investment holdings at December 31, 2003. State Fund receives collateral in the form of cash and securities for the loaned securities from third parties. Cash collateral received is unrestricted and is recorded on the balance sheet as an asset and a separate liability is recorded representing the obligation to return the collateral.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

E. Property and Depreciation

Depreciation on buildings is computed on a straight-line basis over the estimated useful lives of the buildings (40 to 50 years). Data processing equipment is carried at cost less accumulated depreciation computed on a straight-line basis over the estimated useful lives of the equipment (3 years). Depreciation on office furniture and equipment is computed on a straight-line basis over the estimated useful lives of the assets (3 to 5 years). The costs related to internal use software are capitalized and are depreciated over the estimated useful lives of the assets (3 years).

The aggregate amount of admitted data processing equipment (net of accumulated depreciation) is limited to 3% of State Fund's policyholders' surplus, adjusted for the carrying value of data processing equipment.

F. Losses and Loss Adjustment Expenses

Management records its best estimate of losses and loss adjustment expenses. These liabilities include the estimated future cost of reported claims, the cost of claims incurred but not reported, and expenses related to investigating and settling claims. State Fund does not discount these liabilities. These liabilities are based on actuarial estimates that are subject to considerable uncertainty. Should State Fund's losses develop in the future differently from their historical loss development or those projected by the actuarial methods, actual losses would vary, perhaps significantly, from such actuarial estimates. Any adjustments to these estimates are reflected in operations when known (see note 6).

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

G. Revenue Recognition and Unearned Premiums

State Fund records as premiums written deposit premium and any subsequent additional premiums at the time related billings are issued to policyholders. Deposit premiums are a percentage of estimated annual premiums and are earned pro rata over the policy term. Unearned premiums are the unexpired portion of deposit premiums. State Fund records an estimate for earned but unbilled premium (EBUB) as a direct adjustment to earned premiums. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis is nonadmitted. To the extent that amounts in excess of the 10% are not anticipated to be collected, they are written off against operations in the period that the determination is made. State Fund considers anticipated investment income when determining the existence of a premium deficiency.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

H. Guaranty Fund and Other Assessments

Under the California Insurance Code, all casualty insurance carriers including State Fund are required to participate in the California Insurance Guarantee Association (C.I.G.A.) and the Workers' Compensation Administration Revolving Fund (W.C.A.). C.I.G.A. was established to protect the claimants of insolvent insurance companies. W.C.A. was established to partially fund administration of the workers' compensation system. In 1992, a Workers' Compensation Fraud Assessment was instituted by the State of California to provide funding for investigation and prosecution of workers' compensation fraud. Assessments are determined based on premiums written as defined by the applicable insurance code section. In 2003, Assembly Bill 227 created additional assessments for Uninsured Employers Benefits Trust (U.E.B.T.) and Subsequent Injuries Benefits Trust (S.I.B.T.) Funds. The U.E.B.T. Fund pays for benefits provided to injured employees of illegally uninsured employers while the S.I.B.T. Fund pays for benefits to workers who have suffered serious injury and who are suffering from previous and serious permanent disabilities or physical impairments. All casualty insurance companies, including State Fund, are required by law to bill their policyholders a premium surcharge for recoupment of C.I.G.A., W.C.A., Fraud, U.E.B.T. and S.I.B.T. assessments. Upon payment of an assessment, State Fund establishes a receivable, included in other assets, for the related collections of surcharges from policyholders. Amounts collected in excess of the assessment result in a payable to the assessor which is included in other liabilities.

State Fund recorded a receivable for surcharge recoupments for guarantee fund assessments of $109,851 in 2003. State Fund has surcharged amounts in excess of paid guarantee fund assessments to policyholders and has recorded a liability of $65,960, representing the remaining surcharge payable to C.I.G.A. based on assessments through December 31, 2003. State Fund has an obligation to fund C.I.G.A. for State Fund's portion of worker's compensation insolvencies. State Fund expects to be assessed annually for at least the next 5 years at a rate of 2% of net premiums written. Due to State Fund's inability to estimate future premiums, State Fund has not recorded the ultimate liability of these assessments and the related recoupment receivable from policyholders for these future assessments.

State Fund recorded a receivable for surcharge recoupments for W.C.A. and Fraud assessments of $14,157 in 2003. State Fund has surcharged amounts in excess of paid W.C.A. and Fraud assessments to policyholders and has recorded a liability of $20,828 in 2003, representing the remaining surcharge payable to the State of California, based on assessments through December 31, 2003.

Under the US Longshoremen's and Harbor Workers' (L&H) Compensation Act, all carriers and self insurers writing US L&H policies, including State Fund, are required to make payments into a Special Fund based on a prorated assessment determined by the Secretary of 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 $12,000 in 2003 for future assessments under the US L&H Compensation Act.

I. Due from Adjusting Contracts

State Fund entered into an agreement with the State of California Department of Personnel Administration (DPA) to process claims for other state agencies. State Fund processes the claims and advances medical and compensation benefits to the insured or health provider.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

State Fund is reimbursed by the agency for benefits paid and the cost of processing claims. State Fund records a receivable for these reimbursements. All agencies make deposits in a trust account that is held by State Fund for future billings. The deposit in the Trust related to future billings is recorded as amounts held in trust.

J. Retirement and Post-Retirement Benefit Plans

All State Fund employees participate with other State of California (the State) employees in the State pension and other post-retirement (medical and dental) benefit plans administered by the Public Employees' Retirement System of the State of California (CALPERS). State Fund has no legal obligation for the plans. CALPERS assesses pension expense to participating state agencies based on relative salaries paid to state agency employees to the total salaries paid to all state employees and assesses other post-retirement benefit expense based on relative number of state agency employees to all state employees. State Fund was assessed pension expense of $39,344 and assessed other post-retirement benefits expense of $16,460 in 2003.

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.

2. Matters Relating to the California Department of Insurance

California law imposes risk-based capital (RBC) requirements on admitted California insurance companies. These RBC requirements set forth a calculation to determine required levels of policyholders' surplus and provide certain consequences for failure to meet these requirements. The CDI has asserted that it has the authority under the RBC statute to order State Fund to take certain actions as a consequence of State Fund's failure to meet RBC requirements. Since the State Fund was created under the provisions of the state constitution and established by the legislature, rather than as an admitted carrier that is a licensee of the CDI, the State Fund does not believe the Insurance Commissioner has any authority to control the operations of the State Fund. However, State Fund voluntarily submitted to the CDI a plan for reducing its insurance exposure and increasing its policyholders' surplus. Management believes the State Fund has sufficient assets to pay claims and other liabilities as they become due. The State Fund filed suit against the Insurance Commissioner *(SCIF v. Garamendi)* for a formal legal determination of the issue. This suit is still pending.

State Fund's policyholders' surplus of $2,085,877 as of December 31, 2003 is within the Regulatory Action Level of RBC requirements, if applicable. State Fund's carried policyholders' surplus of $1,449,361 as of December 31, 2002 was also within the Regulatory Action Level of RBC requirements, if applicable. A significant factor in the RBC calculation is the premium growth experienced by State Fund in recent years. State Fund has limited ability to restrict growth due to the mission of the State Fund to insure employers who cannot obtain coverage from traditional insurance carriers.

State Fund's previous auditors issued an adverse opinion on the 2002 financial statements based upon their opinion that State Fund's reserves were understated, and its policyholders' surplus was thereby overstated, by $1.0 billion, or 10% of carried reserves. The CDI completed a limited scope examination of State Fund's 2002 financial statement in October 2003;

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

the CDI also opined, referring to the prior auditors' findings, that State Fund's reserves as of December 31, 2002 were approximately $1.0 billion below its best estimate. State Fund disagreed with the findings of its previous auditors and the CDI. State Fund's appointed actuary, Milliman USA, issued its opinion that State Fund's reserves were adequate as recorded in the 2002 financial statements. Had State Fund recorded the proposed adjustment to increase its reserves by $1.0 billion, its policyholders' surplus as of December 31, 2002 would have been in the Mandatory Control Level range of RBC requirements, if applicable.

In 2004, the Insurance Commissioner filed suit against State Fund *(Garamendi v. SCIF)* in which the Insurance Commissioner seeks an injunction directing State Fund to hire outside consultants designated by the Insurance Commissioner to perform a review of State Fund's operations. The Insurance Commissioner contends that this review is necessary to comply with the requirement in California Senate Bill No. 228 (SB228) that the Insurance Commissioner review and analyze the financial condition, underwriting practices, and rate structure of the State Fund and report to the legislature and the Governor on the potential of reducing rates by July 1, 2004, and every July 1 thereafter. State Fund believes that the Insurance Commissioner has, through numerous filings and examinations, more than sufficient knowledge of the financial condition, underwriting practices, and rate structure of the State Fund to issue a report in compliance with SB228, that the operational review demanded by the Insurance Commissioner exceeds the scope of the review intended by SB228, and that the Insurance Commissioner does not have the authority to require State Fund to bear the cost of this additional review. This suit is still pending.

The CDI has initiated a limited scope examination on State Fund's 2003 financial statement to perform a review of the adequacy of the estimate for loss and loss adjustment expenses. The limited scope examination is currently in process.

3. Investment Securities

The amortized cost and estimated market values of investments in bonds at December 31, 2003 are as follows:

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated market value
U.S. Treasury securities and obligations of U.S. governmental corporations and agencies	$ 4,940,743	$ 69,005	$ (9,571)	$ 5,000,177
Obligations of states and political subdivisions	354,877	14,541	(2,477)	366,941
Public utilities	531,552	37,149	(423)	568,278
Corporate debt securities	3,289,997	153,003	(18,265)	3,424,735
Special revenue	316,667	1,949	(1,217)	317,399
Other government	49,867	—	(47)	49,820
Mortgage-backed securities	3,155,331	61,830	(5,905)	3,211,256
Totals	$12,639,034	$337,477	$(37,905)	$12,938,606

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

Quarterly, State Fund reviews its investment portfolio to determine whether or not declines in market value are other than temporary. Factors in addition to average cost and market value, including credit quality, market analysis, current events and management's judgment, are used to determine whether securities are considered other than temporarily impaired. The securities that are considered to be temporarily impaired are written down to current market value as of the last business day of the respective quarter.

As of December 31, 2003, 89 securities were in an unrealized loss position which resulted in an unrealized loss of $37,905. None of these declines in market value were considered to be other than temporary.

The table below reflects the summary of temporarily impaired financial instruments as of December 31, 2003:

	12 months or under		Over 12 months		Total	
	Amortized cost	Gross unrealized losses	Amortized cost	Gross unrealized losses	Amortized cost	Gross unrealized losses
U.S. Treasury securities and obligation of U.S. governmental corporations and agencies	$ 4,940,743	$ (9,571)	—	—	$ 4,940,743	$ (9,571)
Obligations of states and political subdivisions	354,877	(2,477)	—	—	354,877	(2,477)
Public utilities	531,552	(423)	—	—	531,552	(423)
Corporate debt securities	3,289,997	(18,265)	—	—	3,289,997	(18,265)
Special revenue	316,667	(1,217)	—	—	316,667	(1,217)
Other government	49,867	(47)	—	—	49,867	(47)
Mortgage-backed securities	3,155,331	(5,905)	—	—	3,155,331	(5,905)
	$12,639,034	$(37,905)	—	—	$12,639,034	$(37,905)

The amortized cost and estimated market values of bonds at December 31, 2003, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized cost	Estimated market value
Due in one year or less	$ 290,935	$ 296,202
Due after one year through five years	5,387,224	5,515,200
Due after five years through ten years	3,454,148	3,558,428
Due after ten years	351,396	357,521
Mortgage-backed securities	3,155,331	3,211,255
	$12,639,034	$12,938,606

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

Proceeds from sales and redemptions of investments in bonds during 2003 were $3,678,677. Gross gains of $162,100 and gross losses of $8,967 were realized on these sales.

State Fund's investment policies limit concentration of credit risk by requiring diversification of its investments in any one issuer, industry or geographic region. All of State Fund's investment holdings are held by the California State Controller's Office.

At December 31, 2003, State Fund had $3 million on deposit with the Federal Reserve Bank of Saint Louis (FRBSL) to satisfy U.S. Department of Labor regulations relating to State Fund's issuance of US L&H policies.

The CDI permits State Fund to lend a certain portion of their securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. A third party lending agent has been contracted to lend U.S. Treasury notes and bonds. When State Fund securities are initially loaned, the Fund receives cash collateral equivalent to 102% of the fair value of the securities loaned. Such collateral is adjusted daily and is required at all times to equal at least 100% of the fair value of securities loaned. Collateral securities received are not permitted to be pledged or sold unless the borrower defaults. The maximum loan term is one year. In accordance with State Fund's investment guidelines, cash collateral is invested in short-term investments with maturities matching the related loans. Interest income on these investments is shared by the borrower, the third party lending agent, and State Fund. The aggregate market value of loaned securities was $629,533 at December 31, 2003. Collateral received in respect to these loans consisted of $632,715 in cash and $5,526 in securities at December 31, 2003. A liability is recognized for the cash collateral received. A related asset equal to the market value of the reinvested cash collateral is also recognized. The market value of the reinvested cash collateral was $632,875 at December 31, 2003.

4. Fair Value of Financial Instruments

The carrying value of short-term investments, receivables, and payables approximate fair value due to the short maturities of these investments. The fair value of investments securities is discussed above in note 3.

5. Data Processing Equipment

Data processing equipment as of December 31, 2003 is comprised of the following:

Data processing equipment and software	$125,139
Office furniture and equipment	10,560
	135,699
Accumulated depreciation	(84,153)
	51,546
Less nonadmitted assets	(8,092)
	$ 43,454

Depreciation expense was $10,860 in 2003. 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.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

6. Estimated Liabilities for Loss and Loss Adjustment Expenses

Changes in the estimated liabilities for loss and loss adjustment expenses are summarized as follows:

Estimated liabilities for loss and loss adjustment expenses as of January 1, 2003 (note 2)	$ 9,837,967
Add incurred related to:	
Current year	6,086,204
Prior year	283,534
Total incurred	6,369,738
Less paid related to:	
Current year	733,033
Prior year	2,667,001
Total paid	3,400,034
Estimated liabilities for loss and loss adjustment expenses as of December 31, 2003	$12,807,671

Incurred loss and loss adjustment expenses relating to insured events in prior years increased approximately $284,000 in 2003. This was principally due to greater than expected medical inflation and a higher than expected level of late reported claims in accident year 2002.

State Fund writes all classes of workers' compensation insurance coverages whose risk factors expose the State Fund's reserve estimates to significant variability. Management has identified the major risk factors as the volume of business written by the State Fund and the recently enacted legislative changes affecting California workers' compensation.

The State Fund's premium volume has grown significantly in the last four years. While a significant portion of the growth in 2003 is related to higher rate levels, the underlying exposures for all accident years are much higher than historical levels. The new business may exhibit different development characteristics than the historical business, which adds uncertainty to loss reserving projections. Additionally, recently enacted legislation in California, designed to reduce medical costs, will impact open claims, but the magnitude of the savings is uncertain.

In November 2003, workers compensation reform was mandated by the passage of California Assembly Bill No. 228 and Senate Bill No. 229. These bills provide for major changes in the handling of claims effective January 1, 2004 and apply to outstanding claims as of December 31, 2003. Management has considered reform benefits anticipated as claims are settled in the future for the estimated liabilities for losses and loss adjustment expenses as of December 31, 2003. This adds further uncertainty to reserve estimates, given the newness of the legislation, the complications in interpreting the provisions of the legislation, the difficulties in applying the provisions, and the inability to determine when the benefits will be fully reflected in payment activity.

In April 2004, additional workers' compensation reforms were legislated by the passage of SB 899. Management has not yet determined what impact this recent legislation will have

on estimated liabilities for loss and loss adjustment expenses on claims incurred as of December 31, 2003.

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

The total amount of loss reserves no longer carried due to the purchase of annuities, with the claimant as payee, was $211,266 at December 31, 2003. State Fund remains liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities.

Loss reserves eliminated by annuities issued by the following companies exceeded 1% of Policyholder's Surplus:

GE Financial Assurance	$ 70,394
CGU Life Insurance Company	44,189
Metlife	23,605
Allstate Life Insurance	21,879
Total	$160,067

7. Reinsurance

State Fund cedes insurance risk relating to its workers' compensation business to several reinsurance companies. Reinsurance agreements are used to limit State Fund's maximum liability on insurance claims and to catastrophes, thereby stabilizing losses and providing greater diversification of risk. In accordance with statutory accounting practices, the reinsured risks are treated as though State Fund is not liable for covered losses; however, State Fund remains liable to the extent reinsuring companies are unable to meet their treaty obligations. During 2003, State Fund maintained per claimant excess of loss coverage of $5 million in excess of State Fund's retention of $5 million and per occurrence catastrophe excess of loss coverage of $1.5 billion in excess of State Fund's retention of $10 million. During 2002, State Fund maintained per claimant excess of loss coverage of $5 million in excess of State Fund's retention of $5 million and per occurrence catastrophe excess of loss coverage of $1.0 billion in excess of State Fund's retention of $10 million. In 2003, State Fund added two layers of terrorism coverage to the reinsurance program. Total earned premiums ceded under reinsurance contracts in 2003 was $160,597. Based upon estimated reinsurance recoverable under reinsurance treaties, State Fund's liabilities for unpaid claims were reduced by $488,344 at December 31, 2003, including $132,191 and $92,081 recoverable from Reliastar Life Insurance Company and American Reinsurance Company, respectively.

The Reinsurance Treaties have a "no claims bonus" clause where in the event that no claims arise under the treaties, the reinsures will allow State Fund to commute the treaty, which entitles State Fund to a return premium. The no claims bonus is calculated between four and six months after the expiration of the treaties. The payment of the return premium by the reinsurers to State Fund constitutes the commutation of the treaties, and such payment once effected is regarded as a full and final release of the reinsurers from all liability under the treaties. In 2003, State Fund received a refund of $34,700, which resulted in a commutation of the 4th to 9th layers of the 2002 treaties. The State Fund has not yet given notice to the reinsurers to commute the 2003 treaty coverage, which would entitle State Fund to a return premium of $50,645.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2003—Dollar amounts in thousands

In August 2002, State Fund entered into a Loss Portfolio Transfer agreement with XL Re Ltd and ACE Bermuda Ltd (the Reinsurers). The retroactive reinsurance agreement reinsures losses incurred for accident years 1980 through 1998. Under the agreement, State Fund retains the first $950,000 of aggregate losses under the treaty. The Reinsurers have the liability for the first layer of coverage, which does not exceed 90% of $1,150,000 in aggregate. Upon exhaustion of the first layer, the State Fund will retain net $200,000 of aggregate losses in excess of $2,100,000. The Reinsurers will then have the liability for any aggregate amount in excess of $2,300,000 or second layer up to 90% of $300,000 of aggregate losses. The maximum amount recoverable from the Reinsurers is 90% of $1,450,000.

Under the agreement, State Fund ceded loss reserves of $1,035,000 and paid $728,744, thus recognizing a retroactive gain of $319,756. This gain is a component of policyholders' surplus, segregated from unassigned surplus and reported 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 exceeds the total consideration paid by State Fund for the loss portfolio transfer.

At December 31, 2003, State Fund carried gross loss reserves for the subject losses of $2,211,191. At December 31, 2003, cumulative paid losses are below the $950,000 retention as described above.

8. Commitments and Contingencies

At December 31, 2003, State Fund was committed under the terms of renewable leases for 19 offices and various vehicle and other leases.

The following is a summary of the minimum annual rental commitments:

Year:	
2004	$ 49,705
2005	42,366
2006	30,788
2007	24,061
2008	16,858
Thereafter	37,021
	$200,799

The district office leases generally require additional rental payments comprising State Fund's pro rata share of increases in real estate taxes and building operating expenses. Rental expense under such leases was $25,380 in 2003. Total office rental expense charged to operations, which includes an allocation of rental value to space owned and occupied by State Fund, was $50,093 in 2003. Vehicle and other lease expenses charged to operations were $32,080 in 2003.

In the normal course of business, State Fund is subject to various claims and litigation. In the opinion of State Fund management, the amount of ultimate liability with respect to these suits and claims will not materially affect the results of operations and the financial position of State Fund.

State Fund expects to fund C.I.G.A. for guarantee fund assessments for at least the next 5 years at a rate of 2% of future net premiums written.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES

December 31, 2003—Dollar amounts in thousands

State Fund's total admitted assets as filed in the 2003 Annual Statement is $15,287,008.

State Fund's ten largest exposures to a single issuer/borrower/investment, excluding U.S. government, U.S. government agency securities and those U.S. government money market funds are as follows:

Investment	Investment category	Amount	Percentage of total admitted assets
Ontario	State, Territories, and Possessions	$112,838	0.7%
JP Morgan Chase & Co.	Industrial	95,577	0.6
Citicorp	Industrial	84,879	0.6
Int BK Recon & Dev	Industrial	74,677	0.5
US Bancorp	Industrial	67,640	0.4
Wells Fargo & Co.	Industrial	65,628	0.4
Verizon Communications	Public Utilities and Industrial	60,476	0.4
SBC Communication	Public Utilities and Industrial	59,015	0.4
Emerson Electric Co.	Public Utilities and Industrial	58,771	0.4
Lehman Bros. Holdings Inc.	Industrial	55,616	0.4

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

Rating	Amount	Percentage of total admitted assets
NAIC – 1	$12,639,034	82.7%
NAIC – 2	—	0.0
NAIC – 3	—	0.0
NAIC – 4	—	0.0
NAIC – 5	—	0.0
NAIC – 6	—	0.0

State Fund does not have any preferred stocks.
State Fund does not hold any foreign investments other than Canadian investments.

State Fund's equity interest is as follows:

Investment	Amount	Percentage of total admitted assets
Blackrock Institutional Funds – Money Market Fund	$472,708	3.1%

See accompanying independent auditors' report.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES, CONTINUED

December 31, 2003—Dollar amounts in thousands

State Fund had the following amounts subject to securities lending agreements:

At year end			At end of each quarter		
		% of Total Admitted Assets	1st Quarter	2nd Quarter	3rd Quarter
$632,875	4.1%	$715	$642,042	$699,579	

State Fund had the following invested assets as of December 31, 2003:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount (in thousands)	Percentage	Amount (in thousands)	Percentage
Bonds:				
U.S. treasury securities	$ 1,741,218	12.1%	$ 1,741,218	12.1%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	—	0.0	—	0.0
Issued by U.S. government sponsored agencies	3,199,525	22.1	3,199,525	22.1
Foreign government (including Canada)	49,867	0.3	49,867	0.3
Securities issued by states, territories and possessions, and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	327,021	2.2	327,021	2.2
Political subdivisions of U.S. State, territories, and possessions general obligations	27,856	0.2	27,856	0.2
Revenue and assessment obligations	316,667	2.2	316,667	2.2
Mortgage-backed securities (includes residential and commercial MBS): Pass-through securities:				
Guaranteed by GNMA	397,679	2.8	397,679	2.8
Issued by FNMA and FHLMC	2,295,205	15.9	2,295,205	15.9
CMOs and REMICs:				
Issued by FNMA, FHLMC, or GNMA	462,447	3.2	462,447	3.2
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	3,751,711	26.0	3,751,711	26.0
Unaffiliated foreign securities	69,838	0.5	69,838	0.5
Money Market funds	472,708	3.3	472,708	3.3
Real estate investments	170,336	1.2	170,336	1.2
Cash, short-term investments, and cash collateral for investments	1,153,306	8.0	1,153,306	8.0
Total invested assets	$14,435,384	100.0%	$14,435,384	100.0%

See accompanying independent auditors' report.