STATE COMPENSATION INSURANCE FUND

2004 ANNUAL REPORT

A MESSAGE FROM THE PRESIDENT

DEAR STATE FUND POLICYHOLDER,

JAMES C. TUDOR
ACTING PRESIDENT

Each year, at annual report time, State Fund's President has the opportunity to call attention to significant developments in workers' compensation or share items of interest about our organization. Looking back on prior president's letters that have prefaced our annual reports, I noticed that some of the topics covered were ephemeral even though they seemed very important at the time. The milestones of 2004 were hardly transitory events. That's because 2004 was a watershed year for California workers' compensation system and for the state's economy.

The most significant development by far, was the passage of SB 899, a key component of workers' compensation reform legislation signed by Governor Schwarzenegger on April 19, 2004. Reform efforts have included AB 749, passed three years ago, followed by AB 227 and SB 228, passed two years ago and culminating in 2004's SB 899. This last bill was the capstone of a series of events which affected every major stakeholder in the workers' compensation system. Concerns of labor, industry, insurers, employers, medical providers and regulators were all brought together and SB 899 gave hope to cash-strapped businesses reeling from skyrocketing workers' compensation costs. By building in protections for injured workers and adopting nationally recognized medical guidelines, the reform effort restored credibility to a damaged and widely distrusted system.

What does this mean to California employers? It means reform is here, its direction is clear and it is working. It also means an end to the upward premium spiral that made workers' compensation coverage the number one cost issue for employers.

Workers' compensation rates declined as early as January of 2004, and decreases have continued. State Fund has reduced average rates a cumulative 26.2% over that period. These decreases take time to work through the system. Policy renewal dates, the loss experience of individual classifications as well as employer loss experience will all have an impact on premiums. But the decreases already in place, or in the pipeline, will ultimately benefit State Fund's insured employers.

Reform also played an important role in encouraging carriers to return to the marketplace. This means more choices for employers, and will encourage a greater emphasis on superior service, as well as lower prices. Carriers are once again competing for your business, and that's good news.

Finally, reform legislation and the revitalized marketplace will have a direct impact on State Fund. We grew very rapidly during a four-year period which experienced the greatest instability ever witnessed in California's workers' compensation marketplace. More than two-dozen workers' compensation carriers failed and others withdrew from the marketplace, leaving almost a third of California's insured employers without a market for coverage. Thousands of these employers turned to State Fund.

This unprecedented growth was difficult for State Fund. Finding and training qualified staff, 'ramping up' new systems, and coping with drastically increased volume, tested us as thoroughly as any past crisis we've encountered. I'm pleased to say those days are now behind us. State Fund's professional, dedicated employees gave everything they had during this period. They succeeded in providing coverage to employers and benefits to injured workers without interruption. I commend them for their loyalty, skill and determination. They are the finest group of insurance professionals that I have ever had the pleasure to work with in my more than 30 years of workers' compensation experience.

State Fund's period of rapid growth has ended. Competition for your workers' compensation business is back, and we at State Fund must adjust. Our continued success dictates that we need to create a lean and even more efficient State Fund. Our organization must do more with less resources. We have implemented several initiatives in the areas of organizational structure and electronic systems to make these goals possible. I can assure that you will all see the benefits of these changes in the coming months and years.

In closing, I would like to thank all of you for doing business with State Fund. My commitment to you is the promise of a responsive and increasingly efficient organization. We will not lose sight of our important mission or of our responsibility to California employers and their injured workers.

Sincerely,

CONTENTS

FINANCIAL HIGHLIGHTS

December 31, 2004 and 2003—Dollar amounts in thousands

	2004	2003	Percent change
Assets	18,973,214	15,287,008	24.11%
Premiums Earned	7,918,319	7,633,200	3.74%
Net Investment Income	636,671	689,764	-7.70%
Compensation & Medical Benefits	5,528,283	5,532,996	-0.09%
Claim Expenses	841,684	836,742	0.59%
Net Income	909,570	712,558	27.65%
Policyholders' Surplus	2,862,495	2,085,877	37.23%
Policyholder Dividends Paid	168	5,763	-97.08%
Premiums Earned to Policyholders' Surplus Ratio	2.76622981	3.6594679	

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 statutory statements of admitted assets, liabilities, and surplus of State Compensation Insurance Fund (State Fund) as of December 31, 2004, and the related statutory statement of operations and changes in policyholders' surplus, and cash flows for the year then ended. These financial statements are the responsibility of 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances,but not for the purpose of expressing an opinion on the effectiveness of the State Fund's internal control over financial reporting. Accordingly, we express no such opinion. 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, State Fund prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of California, 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 United 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 Fund as of December 31, 2004, or the results of its operations or its cash flows for the year then ended.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of State Fund as of December 31, 2004 and the results of its operations and its cash flow for the year then ended, on the basis of accounting described in Note 1.

REPORT OF INDEPENDENT AUDITORS, CONTINUED

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

April 29, 2005

<< index

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

December 31, 2004—Dollar amounts in thousands

Admitted Assets	
Bonds, at amortized cost	$16,428,679
Money market fund	250,983
Real estate	175,768
Short-term investments	—
Collateral for loaned securities	928,024
Cash	306,211
Total cash and investments	18,089,665
Premiums in the course of collection	154,593
Earned but unbilled premium	244,491
Reinsurance receivable	9,047
Accrued interest and dividends	165,120
Guarantee fund recoupments	160,071
Due from adjusting contracts	66,423
Data processing equipment, at cost less accumulated depreciation	7,856
Other assets	75,948
Total admitted assets	$18,973,214
Liabilities and Policyholders' Surplus	
Estimated liabilities for:	
Losses	$13,958,848
Loss adjustment expenses	1,500,486
Retroactive reinsurance ceded	(1,035,000)
Collateral for loaned securities	927,218
Unearned premiums	311,793
Reinsurance premiums payable	35,633
Dividends declared and unpaid	3,100
Guarantee fund assessments liability	31,824
Amounts held in trust	84,641
Other liabilities	292,176
Total liabilities	16,110,719
Special surplus for retroactive reinsurance	319,756
Unassigned surplus	2,542,739
Policyholders' surplus	2,862,495
Total liabilities and policyholders' surplus	$18,973,214

See accompanying notes to statutory basis financial statements.

<< index

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

Year ended December 31, 2004—Dollar amounts in thousands

Net premiums earned	$7,918,319
Losses incurred	5,528,283
Loss expenses incurred	841,684
Underwriting and administrative expenses	1,209,942
Total underwriting deductions	7,579,909
Net underwriting income	338,410
Investment income	671,731
Net realized capital losses	(378)
Investment expenses	(34,682)
Net investment income	636,671
Loss on premium charge-offs	(65,511)
Net income, before policyholders' dividends	909,570
Dividends to policyholders	(3,932)
Net income	913,502
Policyholders' surplus, beginning of year	2,085,877
Change in nonadmitted assets	(152,271)
Change in unrealized gains and losses	662
Change in provision for reinsurance	14,725
Policyholders' surplus, end of year	$2,862,495

See accompanying notes to statutory basis financial statements.

STATEMENTS OF CASH FLOWS (STATUTORY BASIS)

Year ended December 31, 2004—Dollar amounts in thousands

Premiums collected net of reinsurance	$7,795,260
Net investment income	662,085
Other expense	(65,511)
Benefits and loss related payments	(3,193,630)
Other underwriting expense	(1,764,153)
Dividends paid to policyholders	(168)
Net cash provided by operations	3,433,883
Proceeds from investments sold, matured, or repaid:	
Bonds	1,336,722
Money market fund	5,983,774
Other	662
Cost of investments acquired:	
Bonds	(5,176,034)
Money market fund	(5,762,049)
Other	(9,829)
Net cash from investments	(3,626,754)
Other cash applied	273,800
Net cash from financing	273,800
Net change in cash and short-term investment	80,929
Cash, short-term investments and cash collateral for loaned securities, beginning of year	1,153,306
Cash, short-term investments and cash collateral for loaned securities, end of year	$1,234,235

See accompanying notes to statutory basis financial statements.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)

December 31, 2004—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 State Fund. As a result of recent market conditions, 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, 2004 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, the change in which is credited or charged directly to policyholders' surplus, consist principally of the following: premiums in the course of collection outstanding over ninety days; non-operating internally developed software costs; 10% of earned but unbilled premiums (EBUB) in excess of collateral specifically held and identifiable; office furniture and equipment and prepaid expenses. 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.
- 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 (SVO) 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 SVO of 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, 2004. State Fund receives collateral in the form of cash and securities for the loaned securities from third parties. Cash collateral received is invested in short-term securities and the market value of the said securities is recorded on the balance sheet as an asset and a separate liability is recorded representing the obligation to return the collateral.

E. Property and Depreciation

Real estate consists primarily of property occupied by State Fund and is stated at depreciated cost. 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 and regulatory environment, and the amount of future expenses required to investigate and settle claims. Management's estimates are reviewed quarterly by a nationally recognized consulting actuarial firm (the Appointed Actuary). The Appointed Actuary is retained in accordance with CDI regulatory provisions as the designee to issue a statement of actuarial opinion that has been reviewed with the board of directors as required by actuarial standards of practice.

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 on a pro-rata basis 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.

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 No. 227 (AB227) 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 for the related collections of surcharges from policyholders, which is recorded under the "guarantee fund recoupments" account for C.I.G.A., and under the "other assets" account for W.C.A, Fraud, U.E.B.T. and S.I.B.T. The amounts collected from the policyholders in excess of the assessment result in a payable to the assessing agency, which is recorded under the "guarantee fund assessments liability" account for C.I.G.A., and under the "other liabilities" account for W.C.A, Fraud, U.E.B.T. and S.I.B.T.

State Fund recorded a receivable for surcharge recoupments for guarantee fund assessments of $160,071 as of December 31, 2004. State Fund has surcharged amounts in excess of paid guarantee fund assessments to policyholders and has recorded a liability of $31,824, representing the remaining surcharge payable to C.I.G.A. based on assessments through December 31, 2004. 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.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)
CONTINUED

December 31, 2004—Dollar amounts in thousands

State Fund recorded a receivable for surcharge recoupments for W.C.A and Fraud assessments of $51,461 as of December 31, 2004. State Fund has surcharged amounts in excess of paid W.C.A. and Fraud assessments to policyholders and has recorded a liability of $31,294, representing the remaining surcharge payable to the State of California, based on assessments through December 31, 2004.

State Fund recorded a receivable for surcharge recoupments for U.E.B.T. and S.I.B.T. assessments of $10,530 as of December 31, 2004. State Fund has surcharged amounts in excess of paid U.E.B.T. and S.I.B.T. assessments to policyholders and has recorded a liability of $3,966, representing the remaining surcharge payable to the State of California, based on assessments through December 31, 2004.

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 pro-rated 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 $14,000 as of December 31, 2004 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 on behalf of other state agencies. State Fund processes the claims and advances medical and compensation benefits to the insured or health provider. State Fund is reimbursed by the state agencies 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. CALPERS also 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 $63,034 and assessed other post-retirement benefits expense of $23,240 for the year ended December 31, 2004.

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 December 31, 2002. Since 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, State Fund does not believe the Insurance Commissioner has any authority to control the operations of State Fund. However, State Fund voluntarily submitted to the CDI a plan for reducing its insurance exposure and increasing its policyholders' surplus. Management believes State Fund has sufficient assets to pay claims and other liabilities as they become due. State Fund filed a suit against the Insurance Commissioner *(SCIF v. Garamendi)* for a formal legal determination of the issue. On December 10, 2004, the Honorable Paul Alvarado of the San Francisco County Superior Court issued a tentative ruling that State Fund was subject to the RBC statute, Insurance Code Section 739 et seq, as a matter of law. The ruling was confirmed in Judge Alvarado's Final Statement of Decision on March 25, 2005, thereby concluding Phase I of the trial. Phase II will consider the issue of whether or not the Insurance Commissioner's application of the RBC requirements to State Fund was warranted. On April 12, 2005, State Fund and CDI agreed to a 30-day stay of all proceedings in this case in order to pursue the resolution of the issues.

State Fund's policyholders' surplus of $2,862,495 as of December 31, 2004 is within the Company Action Level of the RBC requirements as compared to $2,085,877 as of December 31, 2003, which was within the Regulatory Action Level of the RBC requirements. 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 its mission to insure employers who cannot obtain coverage from traditional insurance carriers.

In 2004, the Insurance Commissioner filed a suit against State Fund *(Garamendi v. SCIF)* in which the Insurance Commissioner sought 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 contended that this review was 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 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 opposed the suit arguing that the Insurance Commissioner has, through the evaluation of State Fund's rate filings and numerous examinations, more than sufficient knowledge of the financial condition, underwriting practices, and rate structure of State Fund to issue a report in compliance with SB228, that the operational review demanded by the Insurance Commissioner exceeded 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. The Insurance Commissioner withdrew his suit against State Fund in May of 2004.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)
CONTINUED

December 31, 2004—Dollar amounts in thousands

The CDI conducted a limited scope examination on State Fund's reserves as of December 31, 2003 but did not issue a final report on its findings. However, in their October 2004 SB228 Report to the Legislature and the Governor, the CDI commented on the financial condition of State Fund as of December 31, 2003 and subsequent 2004 financial activity. In this SB228 Report, the CDI stated that their actuaries estimated that State Fund's reserves were inadequate by $754 million as of December 31, 2003. If State Fund's surplus were adjusted to correct for this alleged reserve deficiency, it would be reduced to approximately $1.33 billion, causing policyholders' surplus to fall within the Authorized Control Level of the RBC requirements as of December 31, 2003. The CDI is currently reviewing State Fund's reserve adequacy as of December 31, 2004.

The SB228 report comments on the uncertainty in the estimation of the loss reserve requirements and in estimates of savings to be achieved from recently enacted reforms, which emphasizes the variability inherent in the actuarial reserving process. The CDI acknowledged that the financial health of State Fund is improving and plans no action at this time.

3. Investment Securities

The amortized cost and estimated market values of investments in bonds at December 31, 2004 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	$ 4,772,008	$ 40,403	$(23,795)	$ 4,788,616
Obligations of states and political subdivisions	485,115	9,482	(3,466)	491,131
Public utilities	555,752	23,078	(1,038)	577,792
Corporate debt securities	5,182,225	127,850	(29,254)	5,280,821
Special revenue	648,882	7,481	(4,655)	651,708
Other government	49,894	—	(444)	49,450
Mortgage-backed securities	4,734,803	54,981	(5,773)	4,784,011
Totals	$16,428,679	$263,275	$(68,425)	$16,623,529

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 other than temporarily impaired are written down to current market value as of the last business day of the respective quarter.

As of December 31, 2004, 266 securities were in an unrealized loss position, which resulted in an unrealized loss of $68,425. None of these declines in market value were considered to be other than temporary.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)
CONTINUED

December 31, 2004—Dollar amounts in thousands

The table below reflects the summary of temporarily impaired financial instruments as of December 31, 2004:

	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	$ 4,772,008	$(23,795)	—	—	$ 4,772,008	$(23,795)
Obligations of states and political subdivisions	454,111	(2,145)	31,004	(1,321)	485,115	(3,466)
Public utilities	555,752	(1,038)	—	—	555,752	(1,038)
Corporate debt securities	4,838,120	(16,643)	344,105	(12,611)	5,182,225	(29,254)
Special revenue	637,555	(4,269)	11,327	(386)	648,882	(4,655)
Other government	49,894	(444)	—	—	49,894	(444)
Mortgage-backed securities	4,687,022	(4,818)	47,781	(955)	4,734,803	(5,773)
	$15,994,462	$(53,152)	$434,217	$(15,273)	$16,4289,679	$(68,425)

The amortized cost and estimated market values of bonds at December 31, 2004, 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	$ 1,061,556	$ 1,057,713
Due after one year through five years	6,021,966	6,089,919
Due after five years through ten years	3,982,192	4,053,431
Due after ten years	628,162	638,455
Mortgage-backed securities	4,734,803	4,784,011
	$16,428,679	$16,623,529

Proceeds from sales and redemptions of investments in bonds during 2004 were $1,336,722. Gross gains of $1,829 and gross losses of $2,207 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. Per Insurance Code Section 11788, the State Treasurer's Office is the custodian of State Fund's long-term investment holdings.

At December 31, 2004, 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.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)
CONTINUED

December 31, 2004—Dollar amounts in thousands

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. The securities received as collateral 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 $912,553 at December 31, 2004. Cash collateral received in respect to these loans was $927,218 at December 31, 2004. 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 $928,024 at December 31, 2004.

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, 2004 is comprised of the following:

Data processing equipment and software	$97,719
Office furniture and equipment	65,007
	162,726
Accumulated depreciation	(97,386)
	65,340
Less nonadmitted assets	(57,484)
	$ 7,856

Depreciation expense was $13,233 for the year ended December 31, 2004. 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.

December 31, 2004—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, 2004 (note 2)	$12,807,671
Add incurred related to:	
Current year	6,110,922
Prior year	259,045
Total incurred	6,369,967
Less paid related to:	
Current year	613,075
Prior year	3,105,229
Total paid	3,718,304
Estimated liabilities for loss and loss adjustment expenses as of December 31, 2004	$15,459,334

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

State Fund increased its rates significantly in 2003, 15% on January 1, 2003 and 19% on July 1, 2003, and decreased its rates in 2004 by 2.9% on January 1, 2004 and 7% on July 1, 2004. State Fund's calendar year net earned premium increased 42% in 2003 and 4% in 2004. Since premium is booked as it is collected on monthly payroll reports, 2004 calendar year premium was a blend of premium being booked at four distinct rate levels. While 2004 calendar year premium was slightly higher than 2003 due to residual effect of the 2003 rate increases, underlying exposure was actually down significantly from the prior year.

While a significant portion of the growth in 2004 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 AB227 and SB228. In April 2004, additional workers' compensation reforms were legislated by the passage of SB899. These bills provide for major changes in the handling of claims effective January 1, 2004 and many provisions of the bills apply to outstanding claims as of December 31, 2004. 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, 2004. This adds further uncertainty to reserve estimates, given the newness of the legislation, the lack of historical data on which to estimate the impact of some of the changes, the complications in interpreting the provisions of the legislation, the potential for judicial decisions to retroactively change the aspects of reforms, and the inability to determine when the benefits will be fully implemented in related regulations.

December 31, 2004—Dollar amounts in thousands

The risk factors above, coupled with the variability that is inherent in any reserve estimate, 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 $284,341 as of December 31, 2004. 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	$ 92,996
Aviva Life Insurance Company	43,706
Total	$136,702

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 catastrophes, thereby mitigating the risk associated with such claims and catastrophes. 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 2004, State Fund maintained an underlying per occurrence coverage in aggregate excess of $50 million, $5 million in excess of $5 million retention; catastrophe coverage for a maximum of $1.735 billion in excess of $10 million; and three layers of terrorism coverage for a maximum of $701 million in excess of $234 million. Total earned premium ceded under reinsurance contracts in 2004 was $266,739. Based upon estimated reinsurance recoverable under reinsurance treaties, State Fund's liabilities for unpaid claims on a case basis were reduced by $284,567 at December 31, 2004, including $60,737 and $82,101 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. State Fund has not set up a receivable for the no claims bonus, as the clause had not been exercised as of December 31, 2004.

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.

December 31, 2004—Dollar amounts in thousands

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, 2004, State Fund carried gross loss reserves for the subject losses of $2,200,652. At December 31, 2004, cumulative paid losses are below the $950,000 retention as described above.

8. Commitments and Contingencies

At December 31, 2004, State Fund was committed under the terms of 29 renewable leases for various offices, and various vehicle and other leases.

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

Year:	
2005	$ 47,726
2006	37,524
2007	30,802
2008	20,898
2009	18,741
Thereafter	30,763
	$186,454

The district office leases generally require additional payments comprising State Fund's prorata share of increases in real estate taxes and building operating expenses. Rental expense under such leases was $28,101 in 2004. Total office rental expense charged to operations, which includes an allocation of rental value to space owned and occupied by State Fund, was $53,696 in 2004. Vehicle and other lease expenses charged to operations were $34,563 in 2004.

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.

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.

9. Subsequent Event

On March 4, 2005 and April 19, 2005, State Fund exercised the "no claims bonus" provision of the 2004 reinsurance treaties, which resulted in a commutation of the 1st to 3rd terrorism layers, and 5th to7th and 9th excess of loss layers amounting to $23,187 and $18,200, respectively. On March 15, 2005, the amount of $23,187 was applied against the 1st quarter premium payment to one of the reinsurers.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES

December 31, 2004—Dollar amounts in thousands

State Fund's total admitted assets as filed in the 2004 Annual Statement is $18,973,214.

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 (Province of)	State, Territories, and Possessions	$112,827	0.6%
Alcoa, Inc.	Industrial	85,496	0.5
Target Corporation	Industrial	84,241	0.4
Honeywell International	Industrial	84,079	0.4
General Electric Capital Corporation	Industrial	82,546	0.4
American Express	Industrial	80,997	0.4
SLM Corporation	Industrial	80,660	0.4
First Data Corporation	Industrial	80,540	0.4
American Honda Finance	Industrial	79,998	0.4
United Health Group, Inc.	Industrial	79,943	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	$16,428,679	86.6%
NAIC – 2	—	—
NAIC – 3	—	—
NAIC – 4	—	—
NAIC – 5	—	—
NAIC – 6	—	—

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	$250,983	1.3%

See accompanying independent auditors' report.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES, CONTINUED

December 31, 2004—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
$896,115	4.7%	$676,152	$856,290	$936,593

State Fund had the following invested assets as of December 31, 2004:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount (in thousands)	Percentage	Amount (in thousands)	Percentage
Bonds:				
U.S. treasury securities	$ 1,682,708	9.3%	$ 1,682,708	9.3%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	125,211	0.7	125,211	0.7
Issued by U.S. government sponsored agencies	3,013,983	16.6	3,013,983	16.6
Foreign government (including Canada)				
Securities issued by states, territories and possessions, and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	362,177	2.0	362,177	2.0
Political subdivisions of U.S. State, territories, and possessions general obligations	122,938	0.7	122,938	0.7
Revenue and assessment obligations	648,882	3.6	648,882	3.6
Mortgage-backed securities (includes residential and commercial MBS): Pass-through securities:				
Guaranteed by GNMA	336,022	1.8	336,022	1.8
Issued by FNMA and FHLMC	3,917,271	21.7	3,917,271	21.7
All other	172,189	1.0	172,189	1.0
CMOs and REMICs:				
Issued by FNMA, FHLMC, or GNMA	309,321	1.7	309,321	1.7
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	5,658,951	31.3	5,658,951	31.3
Unaffiliated foreign securities	79,026	0.4	79,026	0.4
Money Market funds	250,983	1.4	250,983	1.4
Real estate investments	175,768	1.0	175,768	1.0
Cash and cash collateral for investments	1,234,235	6.8	1,234,235	6.8
Total assets	$18,089,665	100.0%	$18,089,665	100.0%

See accompanying independent auditors' report.

STATE FUND DIRECTORS, OFFICERS, AND LOCATIONS

Board of Directors

Jeanne Cain, Chair
Senior Vice President,
California Chamber of Commerce

J. Kent Dagg
Executive Director,
Shasta Builders' Exchange

Frank DelRe
President,
Western Insurance Administrators, Inc.

Vincent E. Mudd
President,
San Diego Office Interiors

Jim Santangelo
Vice President Western Region,
International Brotherhood of Teamsters
President,
Teamsters Joint Council 42

Robert Alvarado
Executive Officer,
Northern California Carpenters
Regional Council

Jay Hansen
Political and Legislative Director,
State Building and Construction Trades
Council of California

John M. Rea
Acting Director,
State of California
Department of Industrial Relations

Executive Officers

J. C. Tudor
Acting President

J. F. Neary
Executive Vice President and Actuary

Connie Raiche
Vice President

A. Renée Koren
Vice President

Nancy Obertello
Vice President

George Vignolo
Vice President

Charles Savage
Vice President and General Counsel

State Fund Home Office

1275 Market Street
San Francisco, CA 94103
P.O. Box 420807
San Francisco, CA 94142-0807
(415) 565-1234

District Offices

Bakersfield
9801 Camino Media
Bakersfield, CA 93311
(661) 664-4000

Eureka
Humboldt Bank Plaza
2440 Sixth Street
Eureka, CA 95501
(707) 443-9721

Fresno
10 River Park Place East
Fresno, CA 93720
(559) 433-2600 Policy
(559) 433-2700 Claims

Los Angeles
Glendale Claims
655 North Central Avenue
Glendale, CA 91203
(818) 291-7000 Claims

Los Angeles
Monterey Park-Policy Services
900 Corporate Center Drive
Monterey Park, CA 91754
(877) 405-4545 Policy Call Center
(888) 222-3211 Claims Call Center

Oakland
2955 Peralta Oaks Court
Oakland, CA 94605
(510) 577-3184 Policy
(510) 577-3080 Claims

Oxnard
2901 North Ventura Road
Oxnard, CA 93030
(805) 988-5200 Policy
(805) 988-5300 Claims

Redding
364 Knollcrest Drive
Redding, CA 96002
(530) 223-7135 Policy
(530) 223-7000 Claims

Riverside
6301 Day Street
Riverside, CA 92507
(951) 656-8300

Sacramento
2275 Gateway Oaks Drive
Sacramento, CA 95833
(916) 924-5072 Policy
(916) 924-5100 Claims

San Bernardino
375 West Hospitality Lane
San Bernardino, CA 92402
(909) 384-4560 Policy
(909) 384-4500 Claims

San Diego
10105 Pacific Heights Blvd.
San Diego, CA 92121
(858) 552-7000 Policy
(858) 552-7100 Claims

San Francisco
303 Second St., Suite #600
San Francisco, CA 94107
(415) 974-8100 Policy
(415) 974-8200 Claims

San Jose
6203 San Ignacio Avenue
San Jose, CA 95119
(408) 363-7600 Policy
(408) 363-7400 Claims

Santa Ana
1750 East Fourth Street
Santa Ana, CA 92705
(714) 565-5995 Policy
(714) 565-5000 Claims

Santa Rosa
1450 Neotomas Avenue
Santa Rosa, CA 95405
(707) 573-6400 Policy
(707) 573-6500 Claims

South Orange County
1750 East Fourth Street
Santa Ana, CA 92705
(714) 347-5445 Policy
(714) 347-5495 Claims

Stockton
3247 West March Lane
Stockton, CA 95219
(209) 476-2600

Group Insurance

Bay Area Group
1277 Treat Boulevard, Suite 900
Walnut Creek, CA 94597-7975
(510) 777-3500

Sacramento Group
2300 River Plaza Drive, Suite 150
Sacramento, CA 95833
(916) 263-8102

Southern California Group
900 Corporate Center Drive
Monterey Park, CA 91754
(323) 981-6620

Construction Services
2300 River Plaza Drive, Suite 125
Sacramento, CA 95833
(800) 727-5792

Farm Bureau Services
2300 River Plaza Drive, Suite 125
Sacramento, CA 95833
(800) 773-7667

State Contract Offices

Commerce
400 Citadel Drive #100
Commerce, CA 90040
(323) 727-5600

Riverside
6301 Day Street
Riverside, CA 92507
(951) 697-7300

Rohnert Park
5900 State Farm Drive, #200
Rohnert Park, CA 94928
(707) 586-5000

Sacramento
2450 Venture Oaks Way, #500
Sacramento, CA 95833
(916) 567-7500

Oxnard
2901 N. Ventura Road, Suite #100
Oxnard, CA 93036
(805) 988-8600

Special Programs

Claims Management Services
1750 East Fourth Street, #260
Santa Ana, CA 92705
(714) 565-7000

Alternative Dispute Resolution
Program Administration
900 Corporate Center Drive
Monterey Park, CA 91754
(323) 981-6620

Fraud Investigation:

1(888) STOP FRAUD
or (888) 786-7372 (hot line)

Policy Call Center

Toll-Free Number:
(877) 405-4545

24-Hour Claims Reporting

Center Toll-Free Number:
(888) 222-3211

www.scif.com