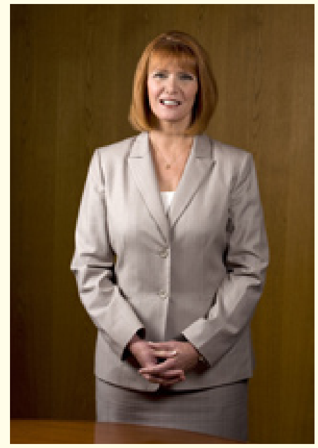
STATE COMPENSATION INSURANCE FUND

2006

ANNUAL REPORT

A MESSAGE FROM THE PRESIDENT



JANET FRANK
PRESIDENT & CEO

State Compensation Insurance Fund's 2006 results demonstrate our solid financial performance, and continued position as the bedrock workers' compensation market for California.

Before we examine the numbers, however, I want to thank our policyholders and brokers for your business and continued confidence in State Fund. As both a competitive market of choice and safety net for California employers seeking workers' compensation insurance, our mission is to promote safe workplaces, minimize the effects of on-the-job injuries, and return injured employees to productive work. It is our privilege to work with you toward these important goals.

Though 2006 marked the beginning of one of the most challenging periods in State Fund's history, we weathered the storm and are emerging an even stronger and more committed organization.

At year's end, State Fund's total assets amounted to $23.1 billion (including long-term investments of $19.9 billion). We had total liabilities (principally reserves for payment of benefits on past claims) of $18.6 billion and a policyholder surplus of $4.5 billion.

Other highlights of our 2006 financial results included: earned premium of $3.5 billion; investment earnings of $924 million; and a net income of $679 million.

These solid results are due in large part to reform legislation passed in 2002, 2003, and 2004 that reduced and stabilized income replacement benefits to injured employees and tamed medical inflation. Workers benefited too as on-the-job injury rates continued their long-term decline and employees got back to work faster.

State Fund achieved savings that directly benefited policyholders and their employees. Our 2006 achievements included:

- An additional 24.4% cumulative rate reduction.
- Further enhancements of State Fund Online, our complete online product serving brokers, policyholders, and associations.
- Full implementation of our Electronic Claims File project, increasing the efficiency of our claims adjusters.
- Sponsorship of more than 100 seminars statewide as part of State Fund's Employer Education Series focusing on important safety topics such as heat-illness prevention, ergonomics, and utility safety.

As State Fund's rates decreased and our premium share returned to more traditional levels, we faced the challenge of declining premiums, lower market share, and other adverse business conditions. Despite a tough competitive market, State Fund increased reserves and surplus, and strengthened our financial position.

During this period State Fund's Board of Directors launched a thorough review of internal management. Initial focus was on the group administrative fee program, but the review was expanded into a broader review of the organization. As a result of the Board's initiative, State Fund has tightened internal controls, strengthened corporate governance, and increased responsible transparency in our operations.

The California economy depends on a financially healthy State Fund. And the high level of industry expertise and the dedication of State Fund's staff have had a tremendous impact on delivering benefits to injured employees and helping employers provide safer workplaces.

What can you expect from State Fund in the future? We will continue to work to strengthen corporate governance, increase efficiency, and bring our procedures into alignment with accepted best practices. We will also be focused on retooling our structure to better meet the needs of California employers and their employees. In addition to reducing expenses, we will align our structure in a way that gives us more flexibility to respond to the marketplace.

In 2006 State Fund completed its 92nd year of non-profit service to the California business community and its employees. Our primary mission since our founding in 1914 has been to provide a permanent and stable market for workers' compensation. Through the many cycles and fluctuations in the market during all those years, we have fulfilled that mission, and will continue to do so. On that you can depend.

Janet D Frank

Janet Frank, PRESIDENT & CEO

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FINANCIAL HIGHLIGHTS

December 31, 2006 and 2005—Dollar amounts in thousands

	2006	2005	Percent change
Assets	23,065,039	21,674,187	6.42%
Premiums Earned	3,477,665	5,946,401	-41.52%
Net Investment Income	923,646	802,630	15.08%
Compensation & Medical Benefits	2,169,250	4,152,685	-47.76%
Claim Expenses	695,050	862,918	-19.45%
Net Income, before policyholder's dividends	679,058	1,018,582	-33.33%
Policyholders' Surplus:	4,496,655	3,785,052	18.80%
Special Surplus for retroactive reinsurance	576,256	576,256	0.00%
Unassigned Surplus	3,920,399	3,208,796	22.18%
Policyholder Dividends Paid	10	(2)	-600.00%
Premiums Earned to Policyholders' Surplus Ratio	0.773389331	1.571022274	

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 policyholders' surplus of State Compensation Insurance Fund (State Fund) as of December 31, 2006 and 2005, and the related statutory statements of operations and changes in policyholders' surplus, and cash flows for the years 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 audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 State Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note 2 to the financial statements, State Fund prepared these financial statements using accounting practices prescribed or permitted by the California Department of Insurance, which practices differ from U.S. generally accepted accounting principles. The effects on the financial statements of the variances between the statutory accounting practices and U.S. generally accepted accounting principles, 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 U.S. generally accepted accounting principles, the financial position of State Fund as of December 31, 2006 and 2005, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of State Fund as of December 31, 2006 and 2005, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note 2.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included on the supplemental schedules 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 audits 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

(signed) KPMG LLP, January 17, 2008

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

December 31, 2006 and 2005—Dollar amounts in thousands

		2006	2005
Admitted Assets			
Bonds, at amortized cost	$	19,584,212	18,300,849
Real estate		283,542	175,636
Cash, cash equivalents and short-term investments		2,151,768	2,136,491
Receivables for securities		75,000	—
Total cash and investments		22,094,522	20,612,976
Premiums in the course of collection		81,407	149,136
Deferred, earned but unbilled and accrued retrospective premiums		95,389	164,226
Reinsurance receivable		14,420	26,205
Accrued interest and dividends		207,833	190,577
Guaranty fund recoupments		293,092	269,373
Due from adjusting contracts		59,244	56,231
Data processing equipment, at cost less accumulated depreciation		5,673	8,063
Other assets		213,459	197,400
Total admitted assets	$	23,065,039	21,674,187
Liabilities and Policyholders' Surplus			
Estimated liabilities for:			
Losses	$	15,430,592	15,457,641
Loss adjustment expenses		1,845,183	1,743,321
Retroactive reinsurance ceded		(1,077,779)	(1,217,384)
Collateral for loaned securities		1,799,480	1,282,378
Unearned premiums		131,080	228,177
Reinsurance premiums payable		—	13,420
Dividends declared and unpaid		3,100	3,100
Guaranty fund assessments liability		11,677	8,728
Amounts held in trust		76,904	82,679
Other liabilities		348,147	287,075
Total liabilities		18,568,384	17,889,135
Special surplus for retroactive reinsurance		576,256	576,256
Unassigned surplus		3,920,399	3,208,796
Policyholders' surplus		4,496,655	3,785,052
Total liabilities and policyholders' surplus	$	23,065,039	21,674,187

See accompanying notes to statutory basis financial statements.

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

December 31, 2006 and 2005—Dollar amounts in thousands

	2006	2005
Net premiums earned	$ 3,477,665	5,946,401
Losses incurred	2,169,250	4,152,685
Loss adjustment expenses incurred	695,050	862,918
Underwriting and administrative expenses	730,413	906,662
Total underwriting deductions	3,594,713	5,922,265
Net underwriting income (loss)	(117,048)	24,136
Investment income	1,030,749	871,472
Net realized capital gains (losses)	(3,196)	3,661
Investment expenses	(103,907)	(72,503)
Net investment income	923,646	802,630
Other income (loss):		
Retroactive reinsurance gain	—	256,500
Loss on premiums charged off	(127,540)	(64,684)
Net income, before policyholders' dividends	679,058	1,018,582
Dividends to policyholders	10	(2)
Net income	679,048	1,018,584
Policyholders' surplus, beginning of year	3,785,052	2,862,495
Change in nonadmitted assets	51,799	(97,528)
Change in unrealized gains and losses	18	207
Change in provision for reinsurance	(19,262)	1,294
Policyholders' surplus, end of year	$ 4,496,655	3,785,052

See accompanying notes to statutory basis financial statements.

STATEMENTS OF CASH FLOWS (STATUTORY BASIS)

December 31, 2006 and 2005—Dollar amounts in thousands

		2006	2005
Premiums collected net of reinsurance	$	3,556,812	5,850,825
Net investment income		954,768	833,369
Other income (expense)		(127,540)	191,816
Benefits and loss related payments		(2,184,514)	(2,671,049)
Other underwriting expense		(1,327,261)	(1,715,381)
Dividends paid to policyholders		(10)	2
Net cash provided by operations		872,255	2,489,582
Proceeds from investments sold, matured, or repaid:			
Bonds		3,136,809	2,709,102
Other		1,655	4,589
Cost of investments acquired:			
Bonds		(4,462,298)	(4,633,073)
Other		(189,134)	(4,238)
Net cash used in investments		(1,512,968)	(1,923,620)
Other cash provided		655,990	85,311
Net cash provided by financing and miscellaneous sources		655,990	85,311
Net change in cash, cash equivalents and short-term investments		15,277	651,273
Cash, cash equivalents and short-term investments, beginning of year		2,136,491	1,485,218
Cash, cash equivalents and short-term investments, end of year	$	2,151,768	2,136,491

See accompanying notes to statutory basis financial statements.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)

December 31, 2006 and 2005—Dollar amounts in thousands

1. History and Business

State Compensation Insurance Fund (State Fund) is a public enterprise fund established by the State of California through legislation enacted in 1913 to provide an available market for workers' compensation insurance to employers located in California. The State of California is not liable for any obligations of State Fund.

State Fund is vulnerable to catastrophes, such as earthquakes and terrorist acts, which have not had significant adverse effects on operations in the past, but could present risks in the future. State Fund purchases reinsurance protection, as more fully described in note 8, to mitigate losses from catastrophic events.

2. Summary of Significant Accounting Policies

A. Basis of Presentation

The statutory basis financial statements of State Fund have been prepared in conformity with accounting practices prescribed or permitted by the California Department of Insurance (CDI), and in accordance with the National Association of Insurance Commissioners' (NAIC) Accounting Practices and Procedures Manual, to the extent those practices and procedures do not conflict with the California Insurance Code. California Insurance Code Section 11558 requires companies to maintain a prescribed minimum reserve of loss and loss adjustment expenses for certain liability coverage, 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 as of December 31, 2006 and 2005, since carried loss and loss adjustment expense reserves exceed the CDI minimum prescribed requirement.

Statutory accounting practices differ in certain respects from the U.S. generally accepted accounting principles, as prescribed by the Governmental Accounting Standards Board (GASB). The significant differences from GASB are as follows:

- Investment in bonds and money market instruments, including commercial paper are carried principally at amortized cost, whereas under GASB such investments would be carried at estimated fair value with changes in fair 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 of the following: premiums in the course of collection which remain outstanding over ninety days, plus all related amounts due that have been recorded on those policies; non-operating internally developed software costs; 10% of earned but unbilled premiums (EBUB) in excess of collateral specifically held and identifiable on a per policy basis; 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party or collateral, not otherwise used; office furniture and equipment, and prepaid expenses. Under GASB, these assets would be included in total assets to the extent realizable.
- Gains on the retroactive reinsurance contract are recognized in income and established as segregated surplus. GASB requires the gains to be deferred and recognized over the estimated settlement period of the reinsured losses, using either a recovery or interest method.

- Policyholders' dividends are accrued when declared, whereas under GASB they are accrued based on amounts to be paid.
- Fees received for processing the claims of other self-insured State of California departments are netted against loss adjustment expenses, whereas under GASB they are recorded as other income.
- Self-rent is included as income and expense, whereas it is excluded 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, cash equivalents and short-term investments, instead of cash and cash equivalents. Short-term investments include securities with maturities, at the time of acquisition, of one year or less. In addition, there is no reconciliation between net income and cash from operations as there would be under GASB.
- A provision for reinsurance is recorded as a liability with a corresponding adjustment to policyholders' surplus for the reinsurance recoverables from unauthorized reinsurance carriers with inadequate collateral, and reinsurance receivables over ninety days, plus all related amounts due that have been recorded on those reinsurance receivables. Under GASB, such a provision for reinsurance is not recognized.

B. Use of Estimates in the 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, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. The most significant estimates inherent in these statutory financial statements are the liabilities for losses and loss adjustment expenses.

C. Cash and Cash Equivalents

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

D. Investments

Investments in bonds are valued in accordance with the requirements of the Securities Valuation Office (SVO) of the NAIC. Bonds are generally stated at amortized cost, except bonds that are defined by the NAIC as Class 3 through 6 which are stated at the lower of amortized cost or NAIC fair value. Amortization is calculated using the scientific to worst constant yield method. Mortgage-backed securities are amortized using anticipated prepayments and are accounted for using the prospective method. Prepayment assumptions for mortgage-backed securities are obtained from various external sources. Money market instruments, including commercial paper are carried at cost, which approximates fair value; while all other short-term investments held in the securities lending program are carried at fair value.

The aggregate fair value of fixed income securities is determined from quotations obtained from the SVO of the NAIC and independent pricing sources. Realized gains or losses on the 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 fair value. 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 continue to be included in the total investment holdings as of December 31, 2006 and 2005. State Fund generally receives cash collateral for the loaned securities. Cash collateral received is invested in short-term securities and recorded on the balance sheet as an asset under the "cash, cash equivalents and short-term investments" account, and a separate liability under the "collateral for loaned securities" account is recorded representing the obligation to return the collateral (see note 4).

Investment expenses consist primarily of expenses incurred in the investing of funds and pursuit of investment income. Such expenses include broker rebate and custodial expenses and agent fees for the securities lending transactions; portfolio management and advisory fees for the short and long-term bonds; alteration to property, repairs and maintenance, utilities, real estate taxes, and other real property expenses for real estate investments.

E. Property and Depreciation

Real estate consists primarily of property occupied by State Fund and is stated at cost less accumulated depreciation. Property held for sale is carried at the lower of depreciated cost or fair value less estimated cost to sell. Depreciation on buildings is computed on a straight-line basis over the estimated useful lives of the buildings (50 years).

Data processing equipment and capitalized internally developed software are carried at cost less accumulated depreciation computed on a straight-line basis over the estimated useful lives of the assets (3 years). Depreciation on office furniture and equipment is computed on a straight-line basis over the estimated useful lives of the assets (5 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. Stated liabilities are based on actuarial estimates that are subject to considerable uncertainty. Should State Fund's losses develop in the future differently than expected from historical experience or differently than expected by current actuarial methods, actual losses could vary, perhaps significantly, from current estimates. Any differences from current recorded estimates will be reflected in operations when known (see note 7).

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 premiums 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 estimates accrued retrospective premiums through the review of each individual retrospectively rated risk, comparing case basis loss development with that anticipated in the policy contract to arrive at the best estimate of return or additional premium. State Fund records accrued retrospective premium as an adjustment to earned premiums. Ten percent of the amount of accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves) or collateral, is nonadmitted.

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 insurance companies writing workers' compensation in California, 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 "guaranty 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 "guaranty 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.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)
CONTINUED

December 31, 2006 and 2005—Dollar amounts in thousands

State Fund recorded the following receivables for surcharge recoupments for the guaranty fund and other assessments as of December 31, 2006 and 2005:

	2006	2005
C.I.G.A.	$ 293,092	269,373
Other assessments		
(W.C.A., Fraud, U.E.B.T. & S.I.B.T.)	90,107	77,607
Totals	$ 383,199	346,980

State Fund recorded liabilities for surcharges payable which consisted of two components: (1) amounts collected in excess of paid guaranty fund and other assessments to policyholders, and (2) accrual for payment to Department of Industrial Relations (DIR) for other assessments billed to State Fund, but not yet due. Following are the liabilities for surcharges payable as of December 31, 2006 and 2005:

	2006	2005
(1) Amounts collected in excess of paid guaranty fund and other assessments to policyholders:		
C.I.G.A.	$ 11,677	8,728
Other assessments		
(W.C.A., Fraud, U.E.B.T. & S.I.B.T.)	85	559
Sub-totals	11,762	9,287
(2) Accrual for payment to DIR for other assessments billed,but not yet due:		
Other assessments		
(W.C.A., Fraud, U.E.B.T. & S.I.B.T.)	16,040	23,340
Sub-totals	16,040	23,340
Totals	$ 27,802	32,627

State Fund has an obligation to fund C.I.G.A. for State Fund's portion of worker's compensation insolvencies.

Under the U.S. Longshoremen's and Harbor Workers' (L&H) Compensation Act, all carriers and self insurers writing U.S. L&H policies, including State Fund, are required to make payments into a Special Fund based on a pro-rated assessment determined by the Secretary of the U.S. Department of Labor. The Special Fund was created to protect injured employees or their survivors by providing for subsequent injuries as defined by the Act. State Fund recorded a liability of $14,000, included in the "other liabilities" account as of December 31, 2006 and 2005, for future assessments under the U.S. L&H Compensation Act.

I. Due from Adjusting Contracts

State Fund has an agreement with the State of California Department of Personnel Administration (DPA) to adjust the claims and process the payments related to those claims on behalf of state agencies. State Fund pays compensation benefits to the injured workers and medical benefits to the health providers. State Fund is reimbursed by the state agencies for compensation and medical benefits paid, and the cost of processing claims. State Fund records a receivable for these reimbursements. All agencies make deposits in a trust account that is held by State Fund for future billings. The deposit in the trust account related to future billings is recorded as amounts held in trust.

J. Retirement and Postretirement Benefit Plans

All State Fund employees participate with other State of California (the State) employees in the State pension and other postretirement (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 postretirement benefit expense based on relative number of state agency employees to all state employees. State Fund was assessed pension expense of $66,814 and $67,979, and assessed other postretirement benefits expense of $38,240 and $29,209 for the years ended December 31, 2006 and 2005, respectively.

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.

3. Risk-Based Capital

California law imposes risk-based capital (RBC) requirements on admitted California insurance companies, including State Fund. These RBC requirements set forth a calculation to determine the required levels of policyholders' surplus and provide certain consequences for failure to meet these requirements. State Fund operates in conformity with the California law imposed for RBC.

As of December 31, 2006 and 2005, State Fund's RBC results show total adjusted capital of $4,496,655 and $3,785,052, respectively, which exceeded the minimum RBC requirements; therefore no action is required by State Fund or the CDI.

December 31, 2006 and 2005—Dollar amounts in thousands

4. Investment Securities

The amortized cost and estimated fair value of investments in bonds as of December 31, 2006 and 2005 are as follows:

	2006			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury securities and U.S. government sponsored enterprise securities	$ 5,606,529	3,090	(62,613)	5,547,006
Obligations of states and political subdivisions	419,048	1,228	(6,777)	413,499
Public utilities	417,720	3,706	(8,802)	412,624
Corporate debt securities	6,020,293	31,999	(109,599)	5,942,693
Special revenue	920,700	5,157	(17,275)	908,582
Other government	49,947	—	(1,455)	48,492
Mortgage-backed securities	6,149,975	11,765	(99,128)	6,062,612
Totals	$ 19,584,212	56,945	(305,649)	19,335,508

	2005			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury securities and U.S. government sponsored enterprise securities	$ 5,399,251	6,559	(72,778)	5,333,032
Obligations of states and political subdivisions	494,073	3,954	(6,751)	491,276
Public utilities	570,364	8,577	(6,149)	572,792
Corporate debt securities	5,466,865	51,905	(95,453)	5,423,317
Special revenue	754,173	10,732	(8,450)	756,455
Other government	49,920	—	(1,543)	48,377
Mortgage-backed securities	5,566,203	14,511	(89,339)	5,491,375
Totals	$ 18,300,849	96,238	(280,463)	18,116,624

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)
CONTINUED

December 31, 2006 and 2005—Dollar amounts in thousands

Included in the mortgage-backed securities as of December 31, 2006 and 2005 are the following:

2006

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
FNMA	$ 2,950,018	4,411	(45,779)	2,908,650
GNMA	337,993	4,744	(3,883)	338,854
FHLMC	2,861,964	2,610	(49,466)	2,815,108
Totals	$ 6,149,975	11,765	(99,128)	6,062,612

2005

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
FNMA	$ 2,439,672	3,161	(42,595)	2,400,238
GNMA	402,278	9,209	(2,420)	409,067
FHLMC	2,724,253	2,141	(44,324)	2,682,070
Totals	$ 5,566,203	14,511	(89,339)	5,491,375

State Fund reviews its investments portfolio to determine whether or not declines in fair value are other than temporary. In addition to average cost and fair value, factors including credit quality, market analysis, current events and management's judgment, are used to determine whether securities are considered other than temporarily impaired. As of December 31, 2006 and 2005, 622 and 748 securities were in an unrealized loss position, which resulted in an unrealized loss of $305,649 and $280,463, respectively. State Fund management believes the unrealized loss position at the end of 2006 and 2005 was a result of the ongoing increases in interest rates over the past two years, rather than due to a material decline in credit quality of State Fund's portfolio holdings. State Fund has the ability to hold the investments for a period of time sufficient to allow it to recover its costs. State Fund concluded that the gross unrealized losses of $305,649 as of December 31, 2006 were temporary in nature.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)
CONTINUED

December 31, 2006 and 2005—Dollar amounts in thousands

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2006 and 2005.

2006

	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 U.S. government sponsored enterprise securities	$ 1,447,103	(3,401)	3,465,202	(59,212)	4,912,305	(62,613)
Obligations of states and political subdivisions	73,476	(1,149)	230,138	(5,629)	303,614	(6,778)
Public utilities	56,339	(607)	259,958	(8,195)	316,297	(8,802)
Corporate debt securities	742,879	(5,741)	3,327,007	(103,858)	4,069,886	(109,599)
Special revenue	268,409	(3,525)	392,764	(13,750)	661,173	(17,275)
Other government	—	—	49,947	(1,455)	49,947	(1,455)
Mortgage-backed securities	1,138,831	(5,607)	3,961,922	(93,520)	5,100,753	(99,127)
Totals	$ 3,727,037	(20,030)	11,686,938	(285,619)	15,413,975	(305,649)

2005

	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 U.S. government sponsored enterprise securities	$ 2,789,959	(30,309)	1,869,349	(42,469)	4,659,308	(72,778)
Obligations of states and political subdivisions	146,842	(2,546)	438,830	(4,205)	585,672	(6,751)
Public utilities	285,508	(4,321)	82,485	(1,828)	367,993	(6,149)
Corporate debt securities	2,107,895	(44,559)	1,865,894	(50,894)	3,973,789	(95,453)
Special revenue	234,916	(4,680)	197,401	(3,770)	432,317	(8,450)
Other government	—	—	49,920	(1,543)	49,920	(1,543)
Mortgage-backed securities	4,272,383	(74,684)	487,490	(14,655)	4,759,873	(89,339)
Totals	$ 9,837,503	(161,099)	4,991,369	(119,364)	14,828,872	(280,463)

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2006 and 2005—Dollar amounts in thousands

The amortized cost and estimated fair value of bonds as of December 31, 2006, 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.

	2006	
	Amortized cost	Estimated fair value
Due in one year or less	$ 3,145,946	3,128,077
Due after one year through five years	6,381,716	6,321,833
Due after five years through ten years	3,049,891	2,976,925
Due after ten years	856,684	846,061
Mortgage-backed securities	6,149,975	6,062,612
Totals	$ 19,584,212	19,335,508

Proceeds from sales and redemptions of investments in bonds during 2006 were $3,136,809, with gross realized gains of $1,608 and gross realized losses of $4,778. Proceeds from sales and redemptions of investments in bonds during 2005 were $2,709,102, with gross realized gains of $11,083 and gross realized losses of $7,436.

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 California Insurance Code Section 11788, the State Treasurer's Office is the custodian of State Fund's long-term investment holdings.

State Fund had $49,762 and $3,000 on deposit with the Federal Reserve Bank of Saint Louis (FRBSL) to satisfy the U.S. Department of Labor regulations relating to State Fund's issuance of U.S. L&H policies as of December 31, 2006 and 2005, respectively.

The CDI permits State Fund to lend a certain portion of its 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, State Fund receives cash collateral equivalent to 102% of the fair value of the securities loaned. Such cash collateral, which is unrestricted, is adjusted daily and is required at all times to equal at least 100% of the fair value of securities loaned. If additional collateral is required to maintain the 100% level, State Fund will receive securities as additional pledged collateral. 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 fair value of loaned securities was $1,768,400 and $1,263,339 as of December 31, 2006 and 2005, respectively. Cash collateral received in respect to these loans was $1,799,480 and $1,282,378 as of December 31, 2006 and 2005, respectively. A liability is established to record State Fund's obligation to return the cash collateral received. A related asset equal to the fair value of the reinvested cash collateral is also recognized. The fair value of the reinvested cash collateral was $1,803,785 and $1,285,599 as of December 31, 2006 and 2005, respectively.

December 31, 2006 and 2005—Dollar amounts in thousands

5. Fair Value of Financial Instruments

The carrying value of money market instruments including commercial paper, receivables, and payables, approximates fair value due to the short maturities of these investments. The fair value of investment securities is discussed above in note 4.

6. Property and Data Processing Equipment

Real estate as of December 31, 2006 and 2005 is comprised of the following:

	2006	2005
Property occupied by the company	$ 331,601	241,418
Property held for sale	23,951	—
	355,552	241,418
Accumulated depreciation	(72,010)	(65,782)
Totals	$ 283,542	175,636

Data processing equipment as of December 31, 2006 and 2005 is comprised of the following:

	2006	2005
Data processing equipment and software	$ 106,491	104,380
Office furniture and equipment	123,142	94,100
	229,633	198,480
Accumulated depreciation	(140,473)	(110,893)
	89,160	87,587
Less nonadmitted assets	(83,487)	(79,524)
Totals	$ 5,673	8,063

Total depreciation expense on property and data processing equipment was $34,146 and $17,868 for the years ended December 31, 2006 and 2005, respectively. The cost of assets retired or otherwise disposed of, and the related accumulated depreciation thereon, are removed from the accounts with any gain or loss realized upon sale or disposal, credited or charged to operations. The nonadmitted assets consist primarily of non-operating internally developed software costs.

December 31, 2006 and 2005—Dollar amounts in thousands

7. Estimated Liabilities for Losses and Loss Adjustment Expenses

The table below reflects the changes in the estimated liabilities for losses and loss adjustment expenses as of December 31, 2006 and 2005. Ceded loss and loss adjustment expense reserves are netted against loss and loss adjustment expense reserves, rather than shown as gross reinsurance recoverable.

	2006	2005
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of $264,796 and $284,567, respectively	$17,200,962	15,459,334
Add incurred related to:		
Current year	2,677,540	4,801,760
Prior years	186,760	213,843
Total incurred	2,864,300	5,015,603
Less paid related to:		
Current year	381,652	499,097
Prior years	2,407,835	2,774,878
Total paid	2,789,487	3,273,975
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of $235,188 and $264,796, respectively	$ 17,275,775	17,200,962

Incurred losses and loss adjustment expenses relating to insured events in prior years increased approximately $186,760 and $213,843 in 2006 and 2005, respectively. State Fund strengthened the reserves in 2006 and 2005 to compensate for the emerging declining closure rate on those years, which pushes payments further into the future and results in a heavier tail.

State Fund writes workers' compensation insurance, a line that exposes State Fund to long-term liabilities with a potential for significant reserve variability. Management has identified the major risk factors in reserve estimation as the growth and contraction of business written by State Fund in recent years, recently enacted legislative changes affecting the line of business (i.e. reform), exposure to the retroactive impact of future legislative, regulatory and judicial decisions, and medical inflation.

State Fund had a significant increase in business volume during the 2002-2003 calendar years. New business added during those years may exhibit different development characteristics than State Fund's historical business. Following that period of growth, in 2004-2005 a significant number of accounts returned to the private insurance market. This growth and contraction of business changes the mix of business over time, impacts development patterns, and contributes an element of uncertainty to loss reserve projections.

Also, in November 2003 the California Legislature passed Assembly Bill 227 and Senate Bill 228, representing a major reform of the workers' compensation system. This was followed in April 2004 by the further reforms of Senate Bill 899. These bills provide for major changes in benefit levels and the administration of claims, impacting both new claims and open claims from earlier accident years. Management has considered the impact of these reforms in estimating future liabilities; however the breadth of the changes and their impact on loss development patterns, and the potential for future legislative, regulatory or judicial decisions to retroactively impact currently estimated liabilities add a level of uncertainty to a current estimate of future liabilities.

December 31, 2006 and 2005—Dollar amounts in thousands

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

These risk factors, coupled with the variability that is inherent in any reserve estimate, could result in material adverse deviation from the carried estimated 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 $354,569 and $345,141 as of December 31, 2006 and 2005, respectively. 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 as of December 31, 2006 and 2005:

	2006	2005
Genworth Financial	$ 108,100	108,507
Hartford Life Insurance	57,558	38,403
Aviva Life Insurance Company	61,702	43,395
Totals	$ 227,360	190,305

8. Reinsurance

State Fund cedes insurance risk relating to its workers' compensation business to several reinsurance companies. Reinsurance agreements limit State Fund's maximum liability on some insurance claims and on 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.

As respects natural catastrophes, State Fund was covered in 2006 by per occurrence excess of loss reinsurance treaties for $1.8 billion of losses excess of $200 million for a catastrophe involving twenty or more claimants. The treaties provided one reinstatement on a pro-rata premium basis as to amount. As respects a terrorist incident, State Fund was covered in 2006 by a combination of private reinsurance and the Federal Terrorism Reinsurance Act (TRIA). Coverage included losses generated from nuclear, biological, chemical or radiological events. Private reinsurance provided $850 million of coverage excess of $200 million on an aggregate annual basis. TRIA provided coverage for certified acts of international terrorism having a minimum industry aggregate impact in excess of $50 million. TRIA coverage was excess of a $1.09 billion State Fund retention, which was partially covered by the previously mentioned private reinsurance.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) CONTINUED

December 31, 2006 and 2005—Dollar amounts in thousands

In 2005, State Fund maintained catastrophe reinsurance of $2.19 billion in excess of $10 million for a non-TRIA catastrophic event, i.e. an event not caused by an act of international terrorism. In respect to events certified by the federal government as acts of international terrorism, State Fund was covered in 2005 by a combination of private reinsurance and the TRIA for losses in excess of $327 million retention.

For the years ended December 31, 2006 and 2005, total earned premiums ceded under the reinsurance contracts were $104,158 and $191,483, respectively. Based upon the estimated reinsurance recoverable under prior reinsurance treaties, State Fund's liabilities for unpaid claims on a case basis were reduced by $235,188 and $264,796 as of December 31, 2006 and 2005, respectively, including $88,770 and $51,766 recoverable from Munich Re America Reinsurance Co. and Reliastar Life Insurance Co., respectively, as of December 31, 2006, and $87,073 and $52,629 recoverable from American Reinsurance Company and Reliastar Life Insurance Company, respectively, as of December 31, 2005.

In 2004 and 2005, certain of the reinsurance treaties had "no claims bonus" clauses whereby, if no claims were made under the treaties, State Fund was entitled to a return premium. The "no claims bonus" provision was triggered by an election by State Fund between four and six months after the expiration of the treaties. The payment of the return premium by the reinsurers to State Fund constituted 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. On March 10, 2005, State Fund exercised the "no claims bonus" provision of the 2004 reinsurance treaties. As a result, a total of $41,387 was received and recognized as income for the year ended December 31, 2005. State Fund did not set up a receivable in 2005 for the 2005 "no claims bonus", as the clause had not been exercised as of December 31, 2005. On March 13, 2006, State Fund exercised the "no claims bonus" provision of the 2005 reinsurance treaties, which resulted in a commutation of the 5th – 7th and 9th excess of loss layers resulting in a $38,412 recognized income for the year ended December 31, 2006. The 2006 treaties do not have "no claims bonus" clauses.

As of December 31, 2006, State Fund commuted reinsurance recoverables (with the companies listed below) of $36,634. These are reflected as losses incurred and loss adjustment expenses incurred amounting to $36,332 and $302, respectively:

Chartwell Reinsurance Co.	$	17,983
Continental Casualty Co.		13,889
Lincoln National Life Insurance Co.		2,672
Trenwick America Reinsurance Co.		2,087
Rochdale Insurance Co.		3
Total	$	36,634

In August 2002, State Fund entered into a Loss Portfolio Transfer agreement (LPT) with XL Re Ltd. and ACE Bermuda Insurance Ltd. (the Reinsurers). The retroactive reinsurance agreement reinsures losses incurred for accident years 1980 through 1998. Under the LPT, 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 covers 90% of next $1,150,000. Upon exhaustion of the first layer, 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. State Fund recorded a deposit of $13,500 (net of 10% retention) with the Reinsurers. The maximum amount recoverable from the Reinsurers is 90% of $1,450,000.

Under the LPT, State Fund ceded loss reserves of $1,035,000 and paid $728,744, thus recognizing a retroactive gain of $319,756. The gain was recorded as 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. Additionally, State Fund received $1,791 as interest on monies held by the Reinsurers prior to the final consummation of the LPT. This resulted in a net amount paid by State Fund of $726,953.

The LPT contains a Large Payment Oversight clause which, if the aggregate of Large Payments (defined as individual payments exceeding $10,000) exceeds tabled values in the treaty (as specified at successive year ends), would void coverage on claims with subsequent Large Payments unless the Reinsurers provide prior written consent for the payments or the State Fund agrees that reimbursement for such payments be apportioned in equal amounts to each calendar year within the life expectancy of the injured employee who is the subject of the claim. Aggregate Large Payments on claims covered by the treaty were below the tabled threshold values as of both year ends covered by the 2006 statement.

As of December 31, 2005, State Fund carried gross loss reserves for the subject losses of $2,600,000. This exceeded State Fund's retention of $2,300,000 and resulted in additional reserves ceded of $270,000 (net of 10% State Fund retention). Accordingly, State Fund recognized an additional retroactive gain of $256,500 (net of $13,500 deposit with Reinsurers). As a result, the special surplus for retroactive reinsurance increased from $319,800 in 2004 to $576,300 in 2005. The special surplus for retroactive reinsurance did not change during 2006.

As of December 31, 2006 and 2005, cumulative subject paid losses were $1,202,468 and $1,047,351, respectively, which exceeded the $950,000 retention. These resulted to a total receivable of $227,221 (net of 10% State Fund retention) and $87,616 (net of 10% State Fund retention) from the Reinsurers, of which $194,349 and $16,832 were collected from the Reinsurers as of December 31, 2006 and 2005, respectively. Net receivables from the Reinsurers were $32,873 and $70,784 as of December 31, 2006 and 2005, respectively.

Effective January 1, 2007, XL Re Ltd. assumed all the rights and obligations of Ace Bermuda Insurance Ltd. to State Fund under the LPT through an Assumption Reinsurance and Novation Agreement.

December 31, 2006 and 2005—Dollar amounts in thousands

9. Commitments and Contingencies

As of December 31, 2006 and 2005, State Fund was committed under the terms of 28 renewable leases for various offices, and various vehicle and other leases.

The following is a summary of the minimum annual lease commitments as of December 31, 2006:

Year:		
2007	$	48,325
2008		42,423
2009		28,450
2010		19,527
2011		4,863
Thereafter		17,717
Total	$	161,305

The district office leases generally require additional payments comprising State Fund's pro-rata share of increases in real estate taxes and building operating expenses. Rental expense under such leases was $33,273 and $30,957 in 2006 and 2005, respectively. Total office rental expense charged to operations, which includes an allocation of rental value to space owned and occupied by State Fund, was $64,537 and $58,292 in 2006 and 2005, respectively. Vehicle and other lease expenses charged to operations were $30,438 and $32,084 in 2006 and 2005, respectively.

State Fund expects to fund C.I.G.A. for guaranty fund assessments for at least the next 2 years at a rate of 2% of future direct 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.

At year end 2006, State Fund was a defendant in two class action lawsuits: the first case asserts a claim for interest on policyholder deposits, and the second case, involving multiple defendants, seeks damages for alleged delays in payment of benefits. State Fund is actively defending against these allegations; and as of December 31, 2006, State Fund does not believe that a loss is probable, estimable or material to year end 2006 policyholders' surplus.

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.

10. Reclassifications

Certain reclassifications have been made to 2005 to conform to the 2006 presentation.

11. Related Party Transactions

The California Insurance Code authorizes the insuring of associations of employers engaged in a common trade or business as a group. During 2006 and 2005, three members of State Fund's Board of Directors held executive positions in organizations which participated in State Fund's group insurance program. The three organizations received administrative fees totaling $18,444 in 2006 and $25,204 in 2005 with one organization receiving $17,816 in 2006 and $24,148 in 2005. Each of the three directors resigned from State Fund's Board during the fourth quarter of 2006 or the first quarter of 2007.

12. Subsequent Events

Subsequent to December 31, 2006, the following events have occurred:

(a) On March 14, 2007, State Fund's Board of Directors received the preliminary results of an internal review and investigation initiated in November, 2006 and conducted by outside counsel and consultants concerning the nature and amount of administrative fees paid pursuant to State Fund's group insurance program. Administrative fees, which are based on a percentage of group premiums, have been paid to administrators of State Fund's participating groups for a variety of reasons including but not limited to the groups' performance of services and exclusive endorsement of State Fund. Such fees totaled $59,604 in 2006 and $99,913 in 2005 and are included in Underwriting and Administrative Fee Expenses in the accompanying Statements of Operations and Changes in Policyholders' Surplus. As a result of the preliminary findings which raised concerns about a lack of oversight and transparency, and the strength of internal controls in the group programs, State Fund suspended the payment of any administrative fees pending the completion of a review of the services provided by each of the 107 groups. On June 6, 2007, State Fund's independent review team reported findings to the Board that confirmed a lack of oversight and transparency and internal control weaknesses with respect to administrative fees and payments to certain vendors. The Board thereafter referred the matter to the California Highway Patrol. On July 25, 2007, the formation of a joint task force comprised of representatives of the California Highway Patrol, the CDI, and the San Francisco District Attorneys' Office was announced. The joint task force is charged with investigating allegations of potential misconduct by former employees of State Fund. State Fund is actively cooperating with the task force in its continuing investigation. Currently, the joint task force is continuing with its investigation and it is not known when that investigation will be complete, nor what action, if any, will be taken by the task force. Additionally, in order to determine which groups' services contractually qualify for payment of administrative fees, State Fund evaluated the performance of each group. Such evaluations were completed in December, 2007.

(b) On March 20, 2007, the President of State Fund resigned. An interim Chief Executive Officer was appointed on March 21, 2007 and served until a permanent President began serving on October 8, 2007.

(c) In April, 2007, the CDI initiated the first phase of an audit of certain aspects of State Fund's operations, including administrative fees. On December 10, 2007, the CDI issued a report covering the first phase of its operational audit. Additionally, the CDI issued its financial examination report of State Fund for years ended December 31, 2003 through December 31, 2006. The CDI accepted the financial statements as filed. The reports included a number of recommendations which are being addressed by management. The CDI is currently conducting the second phase of its operational audit.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES

December 31, 2006—Dollar amounts in thousands

State Fund's total admitted assets as filed in the 2006 Annual Statement is $23,065,039.

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
Wachovia Bank NA	Industrial & Miscellaneous	$ 175,602	0.8%
US Bank NA	Industrial & Miscellaneous	133,983	0.6%
Bank of America Corp.	Industrial & Miscellaneous	132,070	0.6%
Citigroup Inc.	Industrial & Miscellaneous	130,013	0.6%
American Honda Finance Corp.	Industrial & Miscellaneous	129,872	0.6%
JPMorgan Chase & Co.	Industrial & Miscellaneous	127,773	0.6%
Pitney Bowes Credit Corp.	Industrial & Miscellaneous	121,077	0.5%
Proctor & Gamble	Industrial & Miscellaneous	120,966	0.5%
Honeywell International	Industrial & Miscellaneous	120,752	0.5%
CIT Group Inc.	Industrial & Miscellaneous	115,472	0.5%

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

Rating	Amount	Percentage of total admitted assets
NAIC – 1	$ 21,435,844	92.9%
NAIC – 2	—	—
NAIC – 3	—	—
NAIC – 4	—	—
NAIC – 5	—	—
NAIC – 6	—	—

State Fund does not have any preferred stocks.
State Fund's foreign and Canadian investment holdings are less than 2.5% of the total admitted assets.

See accompanying independent auditors' report.

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December 31, 2005—Dollar amounts in thousands

State Fund's total admitted assets as filed in the 2005 Annual Statement is $21,674,187.

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	$ 112,814	0.5%
American Honda Finance	Industrial	99,998	0.5%
United Health Group, Inc.	Industrial	99,568	0.5%
IBM Corporation	Industrial	94,081	0.4%
National Rural Utilities	Industrial	93,266	0.4%
SLM Corporation	Industrial	90,758	0.4%
First Data Corporation	Industrial	88,104	0.4%
United Technologies Corp.	Industrial	85,115	0.4%
Consolidated Ed Co. NY	Industrial	84,957	0.4%
E.I. Du Pont De Nemours	Industrial	84,082	0.4%

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

Rating	Amount	Percentage of total admitted assets
NAIC – 1	$ 19,832,076	91.5%
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	$ 323,875	1.5%

See accompanying independent auditors' report.

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SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES CONTINUED

December 31, 2006—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
$ 1,758,812	7.6%	$ 1,361,323	1,335,435	1,385,673

State Fund had the following invested assets as of December 31, 2006:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	(in thousands)	Amount Percentage	(in thousands)	Amount Percentage
Bonds:				
U.S. treasury securities	$ 2,252,199	10.2	2,252,199	10.2
U.S. government agency obligations				
(excluding mortgage-backed securities):				
Issued by U.S. government agencies	49,946	0.2	49,946	0.2
Issued by U.S. government sponsored agencies	3,354,331	15.2	3,354,331	15.2
Foreign government (including Canada)				
Securities issued by states, territories and possessions,				
and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	266,881	1.2	266,881	1.2
Political subdivisions of U.S. State, territories,				
and possessions general obligations	152,167	0.7	152,167	0.7
Revenue and assessment obligations	920,700	4.2	920,700	4.2
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	200,694	0.9	200,694	0.9
Issued by FNMA and FHLMC	3,759,400	17.0	3,759,400	17.0
All other	152,114	0.7	152,114	0.7
CMOs and REMICs:				
Issued by FNMA, FHLMC, GNMA or VA	2,037,767	9.2	2,037,767	9.2
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit				
tenant loans rated by the SVO)	6,349,042	28.7	6,349,042	28.7
Unaffiliated foreign securities	88,971	0.4	88,971	0.4
Real estate investments:				
Property occupied by the company	266,059	1.2	266,059	1.2
Property held for sale	17,483	0.1	17,483	0.1
Receivables for securities	75,000	0.3	75,000	0.3
Cash, cash equivalents and short-term investments	2,151,768	9.8	2,151,768	9.8
Total cash and investments	$ 22,094,522	100.0	22,094,522	100.0

See accompanying independent auditors' report.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES CONTINUED

December 31, 2005—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
$ 1,262,517	5.8%	$ 989,542	1,310,638	1,283,391

State Fund had the following invested assets as of December 31, 2005:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	(in thousands)	Amount Percentage	(in thousands)	Amount Percentage
Bonds:				
U.S. treasury securities	$ 2,107,719	10.2	2,107,719	10.2
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	49,920	0.2	49,920	0.2
Issued by U.S. government sponsored agencies	3,291,532	16.0	3,291,532	16.0
Foreign government (including Canada)				
Securities issued by states, territories and possessions, and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	352,436	1.7	352,436	1.7
Political subdivisions of U.S. State, territories, and possessions general obligations	141,637	0.7	141,637	0.7
Revenue and assessment obligations	754,173	3.7	754,173	3.7
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	247,124	1.2	247,124	1.2
Issued by FNMA and FHLMC	3,814,548	18.5	3,814,548	18.5
All other	169,929	0.8	169,929	0.8
CMOs and REMICs:				
Issued by FNMA, FHLMC, or GNMA	1,334,603	6.5	1,334,603	6.5
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	5,908,204	28.7	5,908,204	28.7
Unaffiliated foreign securities	129,024	0.6	129,024	0.6
Real estate investments	175,636	0.8	175,636	0.8
Cash, cash equivalents and short-term investments	2,136,491	10.4	2,136,491	10.4
Total cash and investments	$ 20,612,976	100.0	20,612,976	100.0

See accompanying independent auditors' report.

SUPPLEMENTAL PROPERTY & CASUALTY REINSURANCE INTERROGATORIES

December 31, 2006

(1) State Fund has not reinsured any risk with any other entity under a quota share reinsurance contract.

(2) State Fund has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

(a) A contract term longer than two years and the contract is noncancellable by State Fund during the contract term;
(b) A limited or conditional cancellation provision under which cancellation triggers an obligation by State Fund, or an affiliate of State Fund, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
(c) Aggregate stop loss reinsurance coverage;
(d) An unconditional or unilateral right by either party to commute the reinsurance contract except for such provisions which are only triggered by a decline in the credit status of the other party;
(e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
(f) Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

(3) State Fund has not, during the period covered by the statement, ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), where:

(a) The written premium ceded to the reinsurer by State Fund or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or
(b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to State Fund or its affiliates.

(4) State Fund has not ceded any risk under any reinsurance contract during the period covered by the financial statement, and either:

(a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles ("SAP") and as a deposit under generally accepted accounting principles ("GAAP"); or
(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

See accompanying independent auditors' report.

STATE FUND DIRECTORS, OFFICERS, AND LOCATIONS

BOARD OF DIRECTORS

Jeanne Cain, Chair
Executive Vice President
California Chamber of Commerce

Sheryl Chalupa
President and CEO
Goodwill Industries of South
Central California

Vincent Mudd
President
San Diego Office Interiors

James Santangelo
President
Teamsters Joint Council 42
Secretary-Treasurer Teamsters
Local 848

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Corps Reserve (Ret)
Partner
Kester & Quinlan, LLP

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Department of Industrial Relations

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Medical & Regulatory Policy
California Medical Association

Jay Hansen
Legislative & Political Director
State Building & Construction
Trades Council

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Jim Neary
Executive Vice President

John Putnam
Executive Vice President

Connie Raiche
Vice President

Nancy Obertello
Vice President

Linda Hoban
Vice President

Harrison Jerome
Vice President

David West
Vice President

Thomas Clark
Vice President

STATE FUND HOME OFFICE

1275 Market Street
San Francisco, CA 94103
P.O. Box 420807
San Francisco, CA 94142-0807

DISTRICT OFFICES

Bakersfield, 9801 Camino Media
Bakersfield, CA 93311
PO Box 21988
Bakersfield, CA 93390
(661) 664-4000

Bay Area Claims Services
5880 Owens Dr
Pleasanton, CA 94588
(925) 523-5200

Bay Area Policy Services
5880 Owens Dr
Pleasanton, CA 94588
PO Box 429
Pleasanton, CA 94566
(925) 523-5100

Eureka
2440 Sixth St
Eureka, CA 95501
PO Box 4974
Eureka, CA 95502
(707) 443-9721

Fresno
10 River Park Pl E
Fresno, CA 93720
PO Box 40000
Fresno, CA 93755
(559) 433-2700

Inland Empire Claims Services
6301 Day St
Riverside, CA 92507
(951) 656-8300

Inland Empire Policy Services
375 W Hospitality Ln
San Bernardino, CA 92408
PO Box 954
San Bernardino, CA 92402
(909) 384-4560

Los Angeles
Glendale Claims
655 N Central Ave #200
Glendale, CA 91203
PO Box 92622
Los Angeles, CA 90009
(818) 291-7000

Los Angeles
Monterey Park Policy
900 Corporate Center Dr
Monterey Park, CA 91754
PO Box 92503
Los Angeles, CA 90009
(323) 981-6299

Orange County Claims Services
1750 E Fourth St, 3rd Flr
Santa Ana, CA 92705
(714) 565-5000

Orange County Policy Services
1750 E Fourth St, 8th Flr
Santa Ana, CA 92705
PO Box 22022
Santa Ana, CA 92702
(714) 565-5995

Oxnard
2901 N Ventura Rd
Oxnard, CA 93036
PO Box 51410
Oxnard, CA 93031
(805) 988-5300

Redding
2175 Shasta View Drive
Redding, CA 96003
PO Box 496049
Redding, CA 96049
(530) 223-7000

Sacramento
2275 Gateway Oaks Dr
Sacramento, CA 95833
PO Box 254700
Sacramento, CA 95865
(916) 924-5100

San Diego
10105 Pacific Heights Blvd #400
San Diego, CA 92121
PO Box 85531
San Diego, CA 92186
(858) 552-7000

San Jose
6203 San Ignacio Ave
San Jose, CA 95119
PO Box 530960
San Jose, CA 95153
(408) 363-7400

Santa Rosa
1450 Neotomas Ave
Santa Rosa, CA 95405
PO Box 2290
Santa Rosa, CA 95405
(707) 573-6300

Stockton
3247 W March Ln
Stockton, CA 95219
PO Box 208004
Stockton, CA 95208
(209) 476-2600

STATE CONTRACT OFFICES

Commerce
400 Citadel Dr #100
Commerce, CA 90040
PO Box 910932
Commerce, CA 90091
(323) 727-5600

Oxnard
2901 N Ventura Rd #100
Oxnard, CA 93036
PO Box 9230
Oxnard, CA 93031
(805) 988-8600

Riverside
6301 Day St #200
Riverside, CA 92507
PO Box 59901
Riverside, CA 92517
(951) 697-7300

Rohnert Park
5900 State Farm Dr #200
Rohnert Park, CA 94928
PO Box 1609
Rohnert Park, CA 94927
(707) 586-5000

Sacramento
2450 Venture Oaks Wy #500
Sacramento, CA 95833
PO Box 659011
Sacramento, CA 95865
(916) 567-7500

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STATE FUND LOCATIONS, CONTINUED

GROUP INSURANCE

Bay Area Group
5860 Owens Dr
Pleasanton, CA 94588
PO Box 8192
Pleasanton, CA 94588
(925) 523-5950

Farm Bureau
2300 River Plaza Dr #125
Sacramento, CA 95833
(800) 773-7667

Sacramento Area Groups
2300 River Plaza Dr #150
Sacramento, CA 95833
PO Box 254700
Sacramento, CA 95865
(916) 263-8102

Southern California Group
900 Corporate Center Dr, 4th Flr
Monterey Park, CA 91754
PO Box 2004
Monterey Park, CA 91754
(323) 981-6620

SPECIAL PROGRAMS

Alternative Dispute Resolution–
North
5890 Owens Dr
Pleasanton, CA 94588
PO Box 8192
Pleasanton, CA 94588
(925) 533-5950

Alternative Dispute Resolution–
South
900 Corporate Center Dr
Monterey Park, CA 91754
PO Box 2004
Monterey Park, CA 91754
(323) 981-6620

Claims Management Services–
Sacramento
2450 Venture Oaks Wy #230
Sacramento, CA 95833
PO Box 255127
Sacramento, CA 95865
(916) 567-7775

Claims Management Services–
San Bernardino
451 E Vanderbilt Wy #200
San Bernardino, CA 92408
PO Box 1806
San Bernardino, CA 92402
(909) 380-7488

Claims Management Services–
Santa Ana
1750 E Fourth St
Santa Ana, CA 92705
PO Box 11828
Santa Ana, CA 92711
(714) 565-7000

SPECIAL INVESTIGATION UNIT

(888) 786-7372 (hot line)

POLICY CALL CENTER

Toll Free Number:
(877) 405-4545

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Toll-Free Number:
(888) 222-3211

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