STATE COMPENSATION INSURANCE FUND

2007

ANNUAL REPORT

A MESSAGE FROM THE PRESIDENT

JANET FRANK
PRESIDENT & CEO

State Fund has a strong legacy of being the stable, dependable workers' compensation insurance provider for all of California. We plan to build on our 94-year history to continue to provide fair and reliable services that make it possible to give California's employers the assurance that we will be here if they need us.

Established by the California Legislature in 1914, when it made workers' compensation insurance mandatory for employers, State Compensation Insurance Fund is a unique organization.

California legislators created State Fund to fulfill a dual purpose essential to the new workers' compensation insurance market: to be a competitive insurance provider as well as the guaranteed market for any and every California employer seeking coverage. This dual role has enabled State Fund to remain self-supporting for nearly a century, steadfastly serving the employers and injured employees of this state without creating any financial liability to the public.

State Fund continued that legacy of self-sufficiency throughout 2007 while navigating through a period of significant challenges and substantive change. As the year began, our Board of Directors took unprecedented action that led not only to a sweeping redirection of the organization but also to my appointment from private industry to President of this quasi-public enterprise. The Board's decisive action set State Fund on a new course, and since then the organization has made significant progress toward transformative change and sound corporate governance.

Also in 2007 State Fund submitted to a thorough audit by the California Department of Insurance. By the time the Department issued the report of its audit findings, we had already addressed many of the areas of concern identified in that report. We will continue to work collaboratively with the Department of Insurance, the state legislators, and other stakeholders as we also continue to streamline processes where possible, tighten quality control where needed, and enhance our services to our customers and partners where beneficial.

By facing challenges head-on and recognizing the opportunities these challenges created, State Fund has become a stronger organization. Since taking the helm last year, I have continued to steer the company toward greater efficiency and increased transparency. I have often said that organizational change does not occur overnight, but State Fund is diligently moving through the transformation process with a commitment that demonstrates we are prepared to stay the course.

State Fund's 2007 financial performance has supported and reinforced this process of improvement:

- Our surplus grew to $4.9 billion, a 9% increase from 2006.
- Our investment portfolio was valued at $19.6 billion.
- Our investment income was a respectable $961.5 million, a 4.1% increase over 2006.
- Our reserve position remains strong at $16.9 billion.
- Successive rate decreases resulted in a cumulative 55% reduction from the rates in force before the reform legislation became law in 2003 and 2004.
- We finished out the year with $2.27 billion in earned premiums.

Looking beyond the financial front, our accomplishments in 2007 included implementing a broad and popular employer education and outreach program that delivered hundreds of workers' compensation and safety seminars free of charge to employers throughout California. These seminars provide employers with information and ideas that help them comply with regulations and maintain safe worksites, which can lead to reduced workers' compensation costs. In 2008 we continue to offer statewide seminars on an ever-expanding range of topics and look for important partnership opportunities with other safety experts such as the California Highway Patrol on the topic of fleet safety and Cal-OSHA for heat illness prevention. These employer seminars are an important outreach in State Fund's mission to promote workplace safety.

State Fund continued to enhance services, develop products, and streamline processes. We improved and expanded the functionality of our online service tool, State Fund Online, expanding our access to brokers, policyholders and group administrators. And we provided credit extensions to policyholders that suffered business interruptions due to the freeze of January 2007 and the state's wildfires.

Workers' Compensation Reform continued to work as it was intended, serving to reduce medical claims costs, and, by extension, to help stabilize rates and foster competition between carriers. Healthy competition resulted in the continued reduction of our market share, which came in around 25%—closer to our more traditional levels.

BY FACING CHALLENGES HEAD ON AND RECOGNIZING THE OPPORTUNITIES THESE CHALLENGES CREATED, STATE FUND HAS BECOME A STRONGER ORGANIZATION. SINCE TAKING THE HELM LAST YEAR, I HAVE CONTINUED TO STEER THE COMPANY TOWARD INCREASED EFFICIENCY AND GREATER TRANSPARENCY.

The strong financial position we achieved in 2007 enabled State Fund to continue fulfilling its dual role as both a market of choice and the safety net for California employers, while maintaining its distinctive full-service brand of workers' compensation insurance to stakeholders. Our extensive safety services are delivered by a corps of skilled and knowledgeable loss control consultants and representatives. State Fund's rigorous, three-year loss control training program is the most comprehensive occupational safety and health training program for insurance personnel in California. Our top-notch claims function, led by some of the most experienced claims managers in the industry, has consistently performed with the highest marks on regulatory audits. We also offer a group insurance program that covers nearly every industry in California, providing industry-specific loss control services that include industrial hygiene and ergonomics specialties.

Service excellence is key to ensuring that we continue to build a balanced book of business. In 2008, with businesses squeezed by high gas prices and a slowing economy, our expectation is that businesses will be increasingly sensitive to cost and value. We plan to further enhance our training programs and continue streamlining our claims function to ensure that we remain a provider of choice for California employers.

As State Fund approaches the century mark, we are working hard to guarantee that we are well positioned to provide another 100 years of successful service to California employers and their employees. Thank you for your continued support of our unique and important mission.

Janet Frank, PRESIDENT & CEO

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FINANCIAL HIGHLIGHTS

December 31, 2007 and 2006—Dollar amounts in thousands

	2007	2006	Percent change
Assets	21,752,016	23,065,039	-5.69%
Premiums Earned	2,274,908	3,477,665	-34.59%
Net Investment Income	961,471	923,646	4.10%
Compensation & Medical Benefits	1,601,790	2,169,250	-26.16%
Claim Expenses	619,585	695,050	-10.86%
Net Income	326,902	679,048	-51.86%
Policyholders' Surplus:	4,908,725	4,496,655	9.16%
Special Surplus for retroactive reinsurance	576,256	576,256	0.00%
Unassigned Surplus	4,332,469	3,920,399	10.51%
Premiums Earned to Policyholders' Surplus Ratio	0.463441729	0.773389331	

See accompanying notes to statutory basis financial statements.

The Board of Directors
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, 2007 and 2006, 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 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 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 more fully described 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, 2007 and 2006, 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, 2007 and 2006, and the results of its operations and its cash flows 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.

/s/ KPMG LLP, May 30, 2008

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

December 31, 2007 and 2006—Dollar amounts in thousands

		2007	2006
Admitted Assets			
Bonds, at amortized cost	$	19,641,678	19,584,212
Real estate		346,802	283,542
Cash, cash equivalents and short-term investments		970,157	2,151,768
Receivables for securities		—	75,000
Total cash and investments		20,958,637	22,094,522
Premiums in the course of collection		55,266	81,407
Deferred, earned but unbilled and accrued retrospective premiums		70,827	95,389
Reinsurance recoverables		10,238	14,420
Accrued interest and dividends		218,140	207,833
Guaranty fund receivables		210,155	293,092
Due from adjusting contracts		63,083	59,244
Other assets		165,670	219,132
Total admitted assets	$	21,752,016	23,065,039
Liabilities and Policyholders' Surplus			
Estimated liabilities for:			
Losses	$	15,064,949	15,430,592
Loss adjustment expenses		1,865,269	1,845,183
Retroactive reinsurance ceded		(952,203)	(1,077,779)
Collateral for loaned securities		329,377	1,799,480
Unearned premiums		102,604	131,080
Guaranty fund assessments liability		12,155	11,677
Amounts held in trust liability		80,025	76,904
Other liabilities		341,115	351,247
Total liabilities		16,843,291	18,568,384
Special surplus for retroactive reinsurance		576,256	576,256
Unassigned surplus		4,332,469	3,920,399
Policyholders' surplus		4,908,725	4,496,655
Total liabilities and policyholders' surplus	$	21,752,016	23,065,039

See accompanying notes to statutory basis financial statements.

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

December 31, 2007 and 2006—Dollar amounts in thousands

	2007	2006
Net premiums earned	$ 2,274,908	3,477,665
Losses incurred	1,601,790	2,169,250
Loss adjustment expenses incurred	619,585	695,050
Underwriting and administrative expenses	639,545	730,423
Total underwriting deductions	2,860,920	3,594,723
Net underwriting loss	(586,012)	(117,058)
Investment income	1,108,597	1,030,749
Net realized capital losses	(34,809)	(3,196)
Investment expenses	(112,317)	(103,907)
Net investment income	961,471	923,646
Loss on premiums charged off	(48,557)	(127,540)
Net income	326,902	679,048
Policyholders' surplus, beginning of year	4,496,655	3,785,052
Change in nonadmitted assets	84,669	51,799
Change in net unrealized capital gains (losses)	(228)	18
Change in provision for reinsurance	727	(19,262)
Policyholders' surplus, end of year	$ 4,908,725	4,496,655

See accompanying notes to statutory basis financial statements.

STATEMENTS OF CASH FLOWS (STATUTORY BASIS)

December 31, 2007 and 2006—Dollar amounts in thousands

		2007	2006
Premiums collected net of reinsurance	$	2,280,424	3,556,812
Net investment income		1,020,654	954,768
Recoveries from premiums charged off		37,117	30,436
Benefits and loss related payments		(1,963,250)	(2,184,514)
Other underwriting expenses		(1,132,817)	(1,485,247)
Net cash provided by operations		242,128	872,255
Proceeds from investments sold, matured, or repaid:			
Bonds		4,804,246	3,061,809
Real estate		6,189	—
Short-term investments and other		(23,218)	1,655
Cost of investments acquired:			
Bonds		(4,825,019)	(4,462,298)
Real estate		(76,156)	(114,134)
Net cash used in investments		(113,958)	(1,512,968)
Other cash provided (used)		(1,309,781)	655,990
Net cash provided by (used in) financing and miscellaneous sources		(1,309,781)	655,990
Net change in cash, cash equivalents and short-term investments		(1,181,611)	15,277
Cash, cash equivalents and short-term investments, beginning of year		2,151,768	2,136,491
Cash, cash equivalents and short-term investments, end of year	$	970,157	2,151,768

See accompanying notes to statutory basis financial statements.

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.

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. Effective January 1, 2008 the California Insurance Code Section 11558 no longer requires companies to maintain a prescribed minimum reserve of loss and loss adjustment expenses for writing workers' compensation insurance. Prior to January 1, 2008, this requirement differed from the NAIC statutory practices, which did not have such a minimum reserve 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 short-term investments 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 primarily 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; nonoperating system internally developed software costs; 10% of earned but unbilled premiums (EBUB) in excess of collateral specifically held and identifiable on a per policy basis; 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party or collateral, 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.

- An allocation of rental value to space owned and occupied by State Fund is included in 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 receivable from unauthorized reinsurance carriers with inadequate collateral, and reinsurance recoverables over ninety days, plus all related amounts due that have been recorded on those reinsurance recoverables. 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 (see note 2 (f)).

C. Cash, Cash Equivalents, Short-term Investments and Securities Lending

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.

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 the 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 obligation to return collateral is reported as a separate liability entitled "Collateral for loaned securities."

Short-term investments held as collateral in loaned securities are carried at fair value. All other short-term investments are carried at amortized cost.

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.

The 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.

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.

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. Real Estate, Furniture and Equipment

Real estate consists primarily of office buildings occupied by State Fund and is stated at cost less accumulated depreciation. Real estate held for sale is carried at the lower of depreciated cost or fair value less estimated cost to sell. 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

In California, all insurers writing workers' compensation, including State Fund, are subject to assessment by the California Insurance Guarantee Association (C.I.G.A.) and the Department of Industrial Relations (D.I.R.) to protect claimants against insurer insolvencies and administer various aspects of the workers' compensation system. The annual C.I.G.A. assessment is currently 2% of direct written premium. The D.I.R. assessment aggregates to approximately 1.4% of direct written premium. Annual assessments are paid in advance, based on prior year premiums with the final assessment based on reported calendar year written premium. Additional amounts owed are included in the guaranty fund assessments liability and the D.I.R. assessments are included in other liabilities. Amounts prepaid in excess of the final assessment amount will be refunded to State Fund or are available for credit against future assessments and included in guaranty fund receivables.

In California, all insurers are required by law to bill their policyholders a premium surcharge to cover such fund assessments. State Fund generally requires the policyholder to pay an estimated surcharge at policy inception. The surcharge relating to unexpired coverage is included in the guaranty fund assessments liability and the D.I.R. assessments are included in other liabilities.

Additional surcharges owed by policyholders are included in guaranty fund receivables and the D.I.R. assessments are included in other assets. State Fund remains liable to assessing agencies should policyholders fail to remit premium surcharges. During 2007, guaranty fund receivables of $40,247 were written off as uncollectible from policyholders.

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

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, 2007 and 2006, 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 is reported as the "Amounts held in trust liability."

J. Retirement and Other Postretirement Benefit Plans

State Fund employees are employees of the State of California (the State). Consequently, State Fund employees participate in the State pension and other postretirement (medical and dental) benefit plans. State Fund is not directly liable for the plans.

The State employee pension plan is administered by the Public Employees' Retirement System of the State of California (CALPERS). The State Fund pays CALPERS the employers' share of its current employees' retirement cost. State Fund paid pension expense of $69,563 and $66,814 for the years ended December 31, 2007 and 2006 respectively.

The State also assesses State Fund other postretirement benefits expense based upon the relative number of State Fund employees to all State employees. State Fund was assessed other postretirement benefits expense of $44,288 and $38,240 for the years ended December 31, 2007 and 2006 respectively. The State is currently on a "pay-as-you-go" funding and allocation policy, however, pursuant to the requirements of GASB No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, the State is expected to amend its allocation methodology to include amortization of its accumulated unfunded post retirement obligations. State Fund has not been informed of its prospective allocation and cannot predict with any certainty either the prospective methodology or resulting impact on the annual allocation amounts.

December 31, 2007 and 2006—Dollar amounts in thousands

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.

L. Reclassifications

Certain reclassifications have been made to 2006 to conform to the 2007 presentation.

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, 2007 policyholders' surplus exceeded the minimum RBC requirements.

4. Investment Securities

The amortized cost and estimated fair value of investments in bonds as of December 31, 2007 and 2006 are as follows:

	2007			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury securities and U.S. government sponsored enterprise securities	$ 5,064,113	129,113	(1,212)	5,192,014
Obligations of states and political subdivisions	329,466	1,709	(2,592)	328,583
Public utilities	406,875	5,100	(5,004)	406,971
Corporate debt securities	6,238,947	63,230	(67,253)	6,234,924
Special revenue	1,097,553	11,505	(7,383)	1,101,675
Other government	49,974	—	(85)	49,889
Mortgage-backed securities	6,454,750	38,260	(43,023)	6,449,987
Totals	$ 19,641,678	248,917	(126,552)	19,764,043

	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

December 31, 2007 and 2006—Dollar amounts in thousands

State Fund's mortgage-backed holdings as of December 31, 2007 and 2006 consist solely of securities issued by FNMA, GNMA and FHLMC, as follows:

	2007			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
FNMA	$ 3,174,830	20,110	(19,431)	3,175,509
GNMA	466,548	5,334	(2,708)	469,174
FHLMC	2,813,372	12,816	(20,884)	2,805,304
Totals	$ 6,454,750	38,260	(43,023)	6,449,987

	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

State Fund reviews its investment portfolio to determine whether or not declines in fair value of individual securities held 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, 2007 and 2006, 569 and 622 securities were in an unrealized loss position, which resulted in an unrealized loss of $126,552 and $305,649, respectively. State Fund management believes the unrealized loss position at the end of 2007 and 2006 was not due to a material decline in credit quality of State Fund's portfolio holdings. State Fund has the ability to hold and does not intend to sell these investments prior to a market recovery or to their contractual maturity. As of December 31, 2007, all bonds held by State Fund were rated by the NAIC as Class 1 or Class 2. State Fund concluded that the gross unrealized losses of $126,552 as of December 31, 2007 were temporary in nature.

December 31, 2007 and 2006—Dollar amounts in thousands

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2007 and 2006.

	2007					
	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	$ 24,976	(18)	306,857	(1,194)	331,833	(1,212)
Obligations of states and political subdivisions	72,384	(514)	88,730	(2,078)	161,114	(2,592)
Public utilities	51,062	(366)	142,052	(4,638)	193,114	(5,004)
Corporate debt securities	894,934	(12,371)	2,262,307	(54,882)	3,157,241	(67,253)
Special revenue	192,516	(2,315)	305,378	(5,068)	497,894	(7,383)
Other government	—	—	49,974	(85)	49,974	(85)
Mortgage-backed securities	577,965	(3,863)	3,073,986	(39,160)	3,651,951	(43,023)
Totals	$ 1,813,837	(19,447)	6,229,284	(107,105)	8,043,121	(126,552)

	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)

December 31, 2007 and 2006—Dollar amounts in thousands

The amortized cost and estimated fair value of bonds as of December 31, 2007, 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.

	2007	
	Amortized cost	Estimated fair value
Due in one year or less	$ 2,459,058	2,461,721
Due after one year through five years	6,026,711	6,140,689
Due after five years through ten years	4,095,277	4,118,412
Due after ten years	605,882	593,234
Mortgage-backed securities	6,454,750	6,449,987
Totals	$ 19,641,678	19,764,043

Proceeds from sales and redemptions of investments in bonds during 2007 were $4,729,246 with gross realized gains of $559 and gross realized losses of $11,066. 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.

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 $55,376 and $49,762 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, 2007 and 2006, respectively.

The aggregate fair value of loaned securities was $333,957 and $1,768,400 as of December 31, 2007 and 2006, respectively. Cash collateral received in respect to these loans was $329,377 and $1,799,480 as of December 31, 2007 and 2006, respectively. For 2007, additional noncash collateral of $7,011 which is restricted, was received in the form of U.S. Treasuries. The fair value of all collateral was $313,995 and $1,803,785 as of December 31, 2007 and 2006, respectively.

The fair value of the reinvested cash collateral was $306,984 and $1,803,785 as of December 31, 2007 and 2006, respectively.

During 2007 State Fund reinvested cash collateral of $49,355 in commercial paper issued by a structured investment vehicle (SIV). The SIV primarily invested in collateralized debt obligations with significant underlying exposure to subprime mortgages. The SIV has defaulted on its commercial paper obligations. At December 31, 2007 the investment was written down to an estimated fair value of $25,000, with the loss of $24,355 included in net realized capital losses. Fair value is based on the present value of estimated cash flows of the underlying investments held by the SIV. Management does not believe State Fund has any additional material subprime mortgage exposure.

December 31, 2007 and 2006—Dollar amounts in thousands

Additionally, California Insurance Code Section 11797 does not explicitly grant State Fund the authority to invest in corporate debt securities and money market funds. The CDI has recommended that State Fund limit its investments to those permitted under the California Insurance Code Section 11797.

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. Real Estate, Furniture and Equipment

Real estate as of December 31, 2007 and 2006 is comprised of the following:

	2007	2006
Property occupied by the company	$ 327,585	248,780
Property held for sale	10,016	23,951
Construction in progress	80,138	82,821
	417,739	355,552
Accumulated depreciation	(70,937)	(72,010)
Totals	$ 346,802	283,542

Furniture and equipment as of December 31, 2007 and 2006 is comprised of the following:

	2007	2006
Data processing equipment and software	$ 106,909	106,491
Office furniture and equipment	136,384	123,142
	243,293	229,633
Accumulated depreciation	(175,320)	(140,473)
	67,973	89,160
Less nonadmitted assets	(65,719)	(83,487)
Totals	$ 2,254	5,673

Depreciation expense on real estate was $5,395 and $4,566 for the years ended December 31, 2007 and 2006, respectively. Depreciation expense on furniture and equipment was $34,846 and $29,580 for the years ended December 31, 2007 and 2006, 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 nonoperating system internally developed software costs.

December 31, 2007 and 2006—Dollar amounts in thousands

7. Estimated Liabilities for Losses and Loss Adjustment Expenses

The table below reflects changes in the estimated liabilities for losses and loss adjustment expenses over the prior 12 months through December 31, 2007 and 2006. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of a loss portfolio transfer.

	2007	2006
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of $235,188 and $264,796, respectively	$ 17,275,775	17,200,962
Add incurred related to:		
Current year	1,955,657	2,677,540
Prior years	265,718	186,760
Total incurred	2,221,375	2,864,300
Less paid related to:		
Current year	207,865	381,652
Prior years	2,359,067	2,407,835
Total paid	2,566,932	2,789,487
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of $243,723 and $235,188, respectively	$ 16,930,218	17,275,775

Incurred losses and loss adjustment expenses relating to insured events in prior years increased approximately $265,718 and $186,760 in 2007 and 2006, respectively. Increases to prior year incurred are attributable to the strengthening of loss adjustment expense reserves.

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, a significant number of accounts returned to the private insurance market in 2004–2005. This growth and contraction of business changed the mix of business over time, impacting development patterns, and contributing an element of uncertainty to loss reserve projections.

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, 2007 and 2006—Dollar amounts in thousands

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

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

As a workers' compensation carrier, State Fund has incidental exposure to asbestos and environmental claims. Given that State Fund's book is principally small to medium size businesses, it has no significant exposure aggregations. Asbestos and environmental claims are handled in the routine course of business. Claims are made up on a per claimant basis, and State Fund receives about 400 to 500 asbestos claims per year. At December 31, 2007, State Fund identified 1,837 open asbestos cases with aggregate, outstanding case reserves of $35,000, or an average outstanding case reserve of approximately $19 per claim.

State Fund establishes full case reserves for all reported asbestos and environmental claims. Incurred but not reported (IBNR) reserves are established on the book as a whole and include a provision for development of reserves on reported losses. State Fund's aggregate reserves are established based on in-house analyses, and input from external actuaries and auditors using a variety of reserve techniques, including paid loss development, incurred loss development, counts and averages, and historical loss ratios adjusted to current rate levels.

The total amount of loss reserves no longer carried due to the purchase of annuities, with the claimant as payee, was $354,272 and $354,569 as of December 31, 2007 and 2006, 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, 2007 and 2006:

	2007	2006
Genworth Financial	$ 108,206	108,100
Hartford Life Insurance	83,846	57,558
Aviva Life Insurance Company	74,091	61,702
Totals	$ 266,143	227,360

8. Reinsurance

State Fund is exposed to earthquakes and terrorist acts. These have not had significant adverse effects on operations in the past, but could present risks in the future. State Fund purchases reinsurance protection to mitigate losses from catastrophic events.

State Fund cedes insurance risk relating to its workers' compensation business on multiple reinsurance treaties, to multiple reinsurance companies. Reinsurance agreements mitigate State Fund's liability on some individual claims, on some layers of loss, on some blocks of business and on catastrophic exposure. In accordance with statutory accounting practices, when permissible, the reinsured risks are treated for financial statement purposes as though State Fund is not liable for reinsured losses. State Fund however remains liable for reinsured losses if the reinsuring companies are unable to meet their treaty obligations.

As respects natural catastrophes, State Fund was covered in 2007 by per occurrence excess of loss reinsurance treaties for $1,350,000 of losses excess of $200,000 for a catastrophe involving 40 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 2007 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 $500,000 of coverage excess of a $200,000 retention on an aggregate annual basis. Above $700,000 TRIA provided coverage for 85% of losses related to certified acts of international terrorism having a minimum industry aggregate impact in excess of $50,000. Private reinsurance provided an additional $270,000 of coverage in the 15% TRIA coinsurance corridor above $700,000.

As respects natural catastrophes, State Fund was covered in 2006 by per occurrence excess of loss reinsurance treaties for $1,800,000 of losses excess of $200,000 for a catastrophe involving 40 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 $850,000 of coverage excess of $200,000 on an aggregate annual basis. Above $1,090,000 TRIA provided coverage for 85% of losses related to certified acts of international terrorism having a minimum industry aggregate impact in excess of $50,000.

For the years ended December 31, 2007 and 2006, total earned premiums ceded under the reinsurance contracts were $114,850 and $104,158, respectively.

Based upon the estimated reinsurance recoverable under prior reinsurance treaties, State Fund's liabilities for losses were reduced by $243,723 and $235,188 as of December 31, 2007 and 2006, respectively, including $87,796 and $62,539 recoverable from Munich Re America Reinsurance Co. and Reliastar Life Insurance Co., respectively, as of December 31, 2007, and $88,770 and $51,766 as of December 31, 2006, respectively. State Fund commuted reinsurance recoverables of $10,545 and wrote off reinsurance balances due of $143 as of December 31, 2007.

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

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

By December 31, 2005, State Fund's carried gross loss reserves for the subject losses exceeded the upper limit of the second layer of the treaty. State Fund increased retroactive ceded reserves by an additional $270,000 (the $300,000 in the second layer less State Fund's 10% retention). As a result, State Fund recognized an additional retroactive gain of $256,500 ($270,000 net of a $13,500 deposit with Reinsurers for the coverage). Special surplus for retroactive reinsurance increased from $319,800 in 2004 to $576,300 at year end of 2005. The special surplus for retroactive reinsurance did not change during 2006 and 2007.

As of December 31, 2007 and 2006, cumulative subject paid losses were $1,341,997 and $1,202,468, respectively, which exceeded the $950,000 retention. These netted to a total receivable of $352,797 and $227,221 from the Reinsurers (after State Fund's 10% retention) as of December 31, 2007 and 2006, respectively, of which $323,133 and $194,348 were collected from the Reinsurers as of December 31, 2007 and 2006, respectively. Total net receivables from the Reinsurers were $29,664 and $32,873 as of December 31, 2007 and 2006, respectively.

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 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 2007 statement.

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, 2007 and 2006—Dollar amounts in thousands

9. Commitments and Contingencies

State Fund leases certain office space, furniture, equipment and vehicles under noncancellable operating leases.

The aggregate minimum annual lease payments under such operating leases as of December 31, 2007 were as follows:

Year:		
2008	$	49,135
2009		41,550
2010		31,985
2011		14,400
2012		10,684
Thereafter		13,019
Total	$	160,773

Leases for office space generally require additional payments comprising State Fund's pro-rata share of increases in real estate taxes and building operating expenses. For the years ended December 31, 2007 and 2006, the total rental expense for office space was $64,810 and $64,537, respectively, which included an allocation of rental value to space owned and occupied by State Fund of $32,022 and $31,264, respectively. Vehicle and other lease expenses were $30,837 and $30,438 for the years ended December 31, 2007 and 2006, respectively.

In the normal course of business, State Fund is subject to various claims and litigation. Additionally, State Fund was a defendant in four class action lawsuits: the first case asserts a claim for interest on policyholder deposits, the second case filed at the Workers' Compensation Appeals Board on behalf of injured workers seeks alleged unpaid benefits and penalties for alleged delays in the payment of benefits against multiple defendants, the third case brought by medical providers against multiple defendants seeks damages for alleged outstanding medical bills exceeding the official medical fee schedule, and the fourth case asserts a claim for fees paid to group administrators. State Fund is actively defending against these allegations. 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. 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, 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 with one organization receiving $17,816. Each of the three directors resigned from State Fund's Board during the fourth quarter of 2006 or the first quarter of 2007. In 2007, State Fund paid one of the organizations, where a member of State Fund's Board of Directors held an executive position, a total of $104 for administrative fees.

11. Other Matters

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 $26,693 in 2007 and $59,604 in 2006 and are included in Underwriting and Administrative Expenses. 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.

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.

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, 2007—Dollar amounts in thousands

State Fund's total admitted assets as filed in the 2007 Annual Statement is $21,752,016.

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	$ 175,612	0.8%
Bank of America Corp.	Industrial & Miscellaneous	142,066	0.7%
Honeywell International	Industrial & Miscellaneous	134,044	0.6%
US Bank NA	Industrial & Miscellaneous	132,775	0.6%
IBM International Group Capital	Industrial & Miscellaneous	131,330	0.6%
Pitney Bowes Credit Corp.	Industrial & Miscellaneous	130,818	0.6%
John Deere Capital Corp.	Industrial & Miscellaneous	130,775	0.6%
CISCO Systems Inc.	Industrial & Miscellaneous	130,583	0.6%
Citigroup Inc.	Industrial & Miscellaneous	129,304	0.6%
JPMorgan Chase & Co.	Industrial & Miscellaneous	128,205	0.6%

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	$ 20,104,977	92.4%
NAIC – 2	56,401	0.3%
NAIC – 3	—	—
NAIC – 4	—	—
NAIC – 5	—	—
NAIC – 6	25,000	0.1%

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

See accompanying independent auditors' report.

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
$ 314,908	1.4%	$ 1,523,152	1,637,453	1,444,603

State Fund had the following invested assets as of December 31, 2007:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	(in thousands)	Amount Percentage	(in thousands)	Amount Percentage
Bonds:				
U.S. treasury securities	$ 2,229,897	10.7%	2,229,897	10.7
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	—	—	—	—
Issued by U.S. government sponsored agencies	2,834,216	13.5	2,834,216	13.5
Foreign government (including Canada)	49,974	0.2	49,974	0.2
Securities issued by states, territories and possessions, and political subdivisions in the U.S.:				
States, territories, and possessions general obligations	213,145	1.0	213,145	1.0
Political subdivisions of U.S. State, territories, and possessions general obligations	116,321	0.6	116,321	0.6
Revenue and assessment obligations	1,097,553	5.2	1,097,553	5.2
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	343,354	1.6	343,354	1.6
Issued by FNMA and FHLMC	4,384,661	20.9	4,384,661	20.9
CMOs and REMICs:				
Issued by FNMA, FHLMC, GNMA or VA	1,597,089	7.6	1,597,089	7.6
All other	129,646	0.6	129,646	0.6
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	6,611,927	31.6	6,611,927	31.6
Unaffiliated foreign securities	33,895	0.2	33,895	0.2
Real estate investments:				
Property occupied by the company	336,786	1.6	336,786	1.6
Property held for sale	10,016	0.1	10,016	0.1
Cash, cash equivalents and short-term investments	970,157	4.6	970,157	4.6
Total cash and investments	$ 20,958,637	100.0	20,958,637	100.0

See accompanying independent auditors' report.

The following disclosures are limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1994:

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

(2) State Fund has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:
  (a) A contract term longer than two years and the contract is 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) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders, where:
  (a) The written premium ceded to the reinsurer by State Fund or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or
  (b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to State Fund or its affiliates.

(4) State Fund has not ceded any risk under any reinsurance contract during the period covered by the financial statement, and either:
  (a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles ("SAP") and as a deposit under generally accepted accounting principles ("GAAP"); or
  (b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

State Fund has filed the Reinsurance Attestation Supplement with the CDI and NAIC with no exception.

See accompanying independent auditors' report.

STATE FUND DIRECTORS, OFFICERS, AND LOCATIONS

December 31, 2007 and 2006—Dollar amounts in thousands

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

Francis Quinlan
Brigadier General, U.S. Marine Corps Reserve (Ret)
Partner
Kester & Quinlan, LLP

John Duncan
Director
Department of Industrial Relations

Donald Moulds, PhD
Vice President
Medical & Regulatory Policy
California Medical Association

Jerry Kalmar
Business Manager
Local 39 International Union of Operating Engineers

EXECUTIVE OFFICERS

Janet Frank
President

Jim Neary
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
PO Box 92622
Los Angeles, CA 90009
(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
PO Box 65005
Pinedale, CA 93650
(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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See accompanying notes to statutory basis financial statements.

STATE FUND LOCATIONS, CONTINUED

December 31, 2007 and 2006—Dollar amounts in thousands

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)

CUSTOMER SERVICE CENTER

Toll Free Number:
(877) 405-4545

24-HOUR CLAIMS REPORTING CENTER

Toll-Free Number:
(888) 222-3211

WWW.SCIF.COM

See accompanying notes to statutory basis financial statements.