State Fund Annual Report **2008**

STATE
COMPENSATION
INSURANCE
FUND

STATE FUND HOME OFFICE – SAN FRANCISCO, CA

CONTENTS

Established by the California Legislature in 1914, State Compensation Insurance Fund is a self-supporting, non-profit enterprise that provides workers' compensation insurance to California employers at cost with no financial obligation from the public.

LETTER FROM THE PRESIDENT

Last year, while speaking to the Insurance Education Association, I mused that the rapid changes at State Compensation Insurance Fund were like the shaking of a snow globe. Although it may have felt that way at times, the truth is 2008 was not a year of random swirling—it was a year of conscientious transformation.

No question, Californians will remember 2008 as a year of economic volatility and change. Despite the economic challenges we faced in 2008, State Fund developed and implemented some of the most significant and meaningful changes in recent history. While we have executed a number of initiatives and improvements, our purpose hasn't changed.

Our mission has always been to provide California's businesses with a strong and stable choice for their workers' compensation insurance while making California's workplaces safer and helping injured employees return to work—all with no financial obligation from the public. Our values—honesty, integrity, accountability, excellence in customer service, and long-term commitment to California—continue to provide the guiding principles that shape our company and culture.

Strong Leadership

Building upon that foundation, in 2008 we charted a course of deliberate action to enhance our ability to make California business possible and protect employers and workers.

With the introduction of several key executives, coupled with our tenured staff, we have assembled the most highly qualified leadership team in State Fund's history. The addition of new positions brought State Fund immediate, deep functional expertise and, combined with the exemplary guidance of our talented management team, gives us a leadership structure that provides clear lines of accountability and responsibility for improved decision making, transparency, and performance. Together, they provide the leadership we need to reinforce a corporate culture of honesty, integrity, and transparency.

We also continued to build upon our stability and expertise derived from nearly a century of serving Californians. The introduction of best practices from private industry, including rigorous internal controls and structured executive oversight, provides State Fund a fresh approach and competitive perspective. As a unique blend of the public and private sector, it is our challenge to manage the organizational constraints we are subject to as a state agency while running a successful business. All of California is a stakeholder in our company. State Fund is a part of the very fiber of California's economy, and millions of Californians depend on us every day.

Competitive Perspective

One of our most notable achievements last year was the progress we made responding to the California Department of Insurance (CDI) 2007 report findings. We believe that all companies can benefit from a thorough external review. For State Fund, the CDI presented us with an opportunity to examine our practices, policies, and procedures to determine what has worked well and where we can make improvements. We are pleased that in its 2008 review of our operations, the CDI affirmed the progress State Fund has made, particularly in strengthening corporate governance and internal controls. Specifically, the CDI's progress review reports that State Fund has either resolved or made significant progress on more than 90 percent of the 110 recommendations outlined in the 2007 report.

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Some of State Fund's most significant successes include:

- Audit results that show State Fund's new group program has remediated all concerns by carefully defining expectations, performance metrics, mandatory audits, and financial incentives for safety program participation;
- Significant progress in reducing paid penalties on medical bills;
- Great strides in resolving most of the CDI's findings in the information technology area.

It is important to note that State Fund has achieved these results while at the same time successfully implementing the considerable requirements of SB 1145 and AB 1874, which increase the size of our board and executive team, mandate open board meetings, and provide public records access.

Unique Resource

As we continue to make improvements that ensure our success, we strive to provide services that are responsive to our customers' evolving needs. One way we do that is by actively fighting fraud to help keep costs down for everyone. Workers' compensation fraud drains millions of dollars from the system every year. The most insidious and often misunderstood aspect of fraud is its effect on the California economy. Fraud drives up workers' compensation insurance costs and affects every employer across every industry.

I am proud to say that our Special Investigation Unit (SIU), made up of fraud investigators and investigative liaisons in each regional office, has earned State Fund a reputation as an industry leader in combating fraud. All State Fund employees are required to take regular fraud awareness training, and State Fund's claims adjusters, underwriters, auditors, and employees participate in

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quarterly fraud trend meetings. Furthermore, the SIU and State Fund's Special Litigation Unit work together with law enforcement officials at the local, state, and federal levels.

On the front lines of our business is the fulfilling and rewarding job of assisting in an injured employee's recovery. Through our many offices across California, State Fund is actively involved in the return-to-work process and offers specialized expertise in helping injured employees. Our loss prevention and return-to-work programs—complimentary services available to policyholders—help keep workplaces safe and get employees back to work more quickly.

Fraud prevention and workplace safety programs only begin to scratch the surface of State Fund's deep commitment to the success of California's businesses. Our ability to scale to the businesses we serve makes us uniquely situated to offer reliable workers' compensation insurance to the large and small businesses that make California the most dynamic state in the union. We are reliable, knowledgeable business partners to one in four California businesses.

Focused Direction

With the foundation we solidified in 2008, I am proud to say that we enter 2009 better prepared than ever before to protect California businesses and workers, and the California dream.

In order to build on the progress we made, we have established seven strategic initiatives to guide our work in 2009. These initiatives were identified based on feedback, experiences, and challenges articulated by our employees, customers, and other stakeholders, and provide us with priority and direction.

"Our ability to scale to the businesses we serve makes us uniquely situated to offer reliable workers' compensation insurance to the large and small businesses that make California the most dynamic state in the union."

1. *Stabilize our book of business* – We will focus on retaining existing business, acquiring new business, and improving State Fund's loss and expense ratios.

2. *Build our IT capabilities* – We will streamline workflow, increase our customers' ease of doing business with us, and develop tools that support better decision making by automating online quoting, developing business analytics, and modernizing key business functions.

3. *Manage expenses* – This is an ongoing and critical effort in stabilizing our book of business. We have asked our employees to help us in this endeavor by continuing to identify opportunities to save and prioritize spending.

4. *Enhance our talent management practices* – We will continue our work to develop and retain our employees by introducing individual development plans, a leadership development curriculum, and a formalized succession planning process.

5. *Build our brand* – In 2008, we launched a refreshed brand that was presented to all employees. We will continue to communicate and strengthen our brand position both internally and externally.

6. *Meet or exceed all ethical, compliance, and regulatory commitments* – We have made significant progress in strengthening corporate governance and will continue this work by introducing a formal employee code of conduct and a revised conflict of interest policy, and by providing Model Audit Rule compliance training and education.

7. *Enhance our customer centricity* – As we work to position State Fund for the future, we must ensure that our customers' needs are central to our processes and decisions. In 2008, we expanded our marketing management team and charged

"We are reliable, knowledgeable business partners to one in four California businesses."

them with enhancing State Fund's business practices to better meet our customers' needs and make it easier to do business with us. We will continue this work in 2009.

Stable and Financially Strong

State Fund has supported California's entrepreneurial spirit through wars, depression, earthquakes, and economic cycles. We are in it for the long haul—we have never pulled out of the market due to an economic downturn and we never will. After 26 private carriers became insolvent or left the market between 2001 and 2004, State Fund took on that business and averted an availability crisis for California employers. Since 2004, our market share has returned to more traditional levels as private carriers have re-entered the market.

"We are in it for the long haul—we have never pulled out of the market due to an economic downturn and we never will."

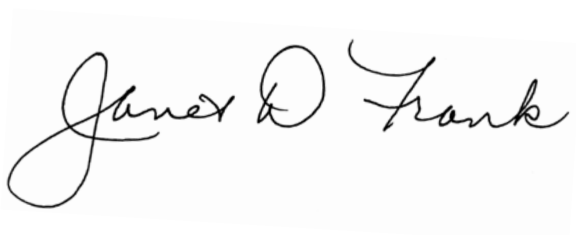
Despite this market adjustment and the economic challenges facing the state and nation, our 2008 financial results reflect State Fund's strong financial position.

- We finished the year with $1.66 billion in earned premiums, compared to $2.27 billion in 2007.
- Our investment portfolio was valued at $18.5 billion, compared to $19.6 billion in 2007.
- Our net investment income was $896.2 million, compared to $961.5 million in 2007.
- Our reserve position remains strong at $15.6 billion, compared to $16.0 billion in 2007.
- Our surplus grew to $5.1 billion, compared to $4.9 billion in 2007.

State Fund's financial strength is the direct result of a conservatively managed investment portfolio that is diversified across issuers and sectors, and carries an average credit quality equivalent to an S&P rating of AA+. With more than 180,000 policyholders, more than $1.6 billion in premium, and nearly $21.1 billion in net admitted assets, State Fund is a necessary, competitive force in California's economy.

We can't yet know all the challenges we will face in 2009, but I have full faith in this company and in this community of people who comprise it. Having seen the work we have already accomplished, I am reassured that we will thrive.

In closing, I want to thank all of our constituents—our policyholders, the brokers and employer associations we work with, our supporters in Sacramento, and, most of all, our employees—for accompanying us on the next leg of the journey.



Janet D. Frank, President & CEO

"Our mission has always been to provide California's businesses with a strong and stable choice for their workers' compensation insurance while making California's workplaces safer and helping injured employees return to work—all with no financial obligation from the public."

JANET FRANK
PRESIDENT & CEO

CYNTHIA RETTER

EXECUTIVE VICE PRESIDENT, THE RULE COMPANY INSURANCE BROKERS

Growing up, I always wanted to be a grammar school teacher. Today, I am a principal at The Rule Company Insurance Brokers. It may seem like a big leap, but I find myself playing educator to our customers daily.

Most customers do not understand insurance so I am here to educate them, because the more informed they are, the better decision makers they become. I hold a deep sense of personal responsibility to protect the current and future assets of our clients. At the end of the day, if someone has a major catastrophe I want to be sure they have the insurance they need.

State Fund launched a pilot program to begin working with brokers in 1993 and I have worked with them ever since. During that time, I have learned a lot about what is important in a workers' compensation provider and why State Fund's knowledge and experience are unmatched in California.

- *Service:* The best accident is the one that never happens, but accidents are a part of life. While we can't always prevent them, we can make sure we have the tools in place to deal with them when they occur. If you get hurt on the job your biggest fears are: how am I going to pay rent, how will I pay for my car, what am I going to do? To have someone reassure an injured employee and explain how workers' compensation works is crucial to getting the person stable and back to work as quickly as possible. State Fund has always had experienced claims people, and they continue to look for ways to improve and expand their services in both loss control and claims.

- *Solutions:* State Fund offers both front-end and back-end solutions that support my clients' businesses. I once had a restaurant owner contact me on December 31 for workers' compensation insurance starting January 1—as in the next day. I contacted the local State Fund district manager on his cell phone, had a quote back the same day, and we got the client covered. I tell customers "we will work it out," because most problems are just challenges that you can work out. Once my clients become State Fund policyholders, they have 24/7 access to see their claims history, to pay their premiums, to download safety materials. I think State Fund Online is the best in the industry; no one else comes close.

- *Value:* I take value seriously. I want to get my customers every dollar of value out of the policies they buy, but most employers tend to focus on price. It's my job to help them recognize that the lowest premium usually doesn't translate into the lowest net cost to their business, nor does it always meet the unique needs of employers and injured workers. When California went to an open rating system in the mid-1990s, a flurry of companies opened their doors in California. Unfortunately, many of them underpriced their products and went out of business. State Fund was there to pick up the pieces, with an open door policy to serve both large and small businesses along with the financial stability to weather economic downturns. The fashion designer, Aldo Gucci, once said, "The bitterness of poor quality is remembered long after the sweetness of low price has faded from memory." I think that is rather apropos to workers' compensation coverage and the importance of a stable and financially strong State Fund.

When presented with the opportunity to switch workers' compensation providers, many of my clients say: "State Fund insured me when I first started my business and they've been with me ever since—why would I leave?" Many businesses would have had to close their doors if it weren't for State Fund. They're not just a safety valve for California; they are a vibrant and reliable workers' compensation provider in the state.

"Many businesses would have had to close their doors if it weren't for State Fund. They're not just a safety valve for California; they are a vibrant and reliable workers' compensation provider in the state."

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CYNTHIA RETTER
EXECUTIVE VICE PRESIDENT,
THE RULE COMPANY INSURANCE BROKERS

MICHAEL MACHADO

CALIFORNIA STATE SENATOR (RETIRED)

When my grandparents immigrated to California from the Azores, a string of islands off the coast of Portugal, in the 1930s, they had nothing to their name and had to build a life from scratch. They started a farm that has been in our family now for three generations. Growing up on that farm, I learned a lot about seeing projects through concept to development to implementation. Every time you plant a seed, you create something that needs to be nurtured to fruition. It's not a perspective many people see in their daily jobs, and not one I expected to see when I joined the California State Legislature in 1994.

When I became an elected official, I made a promise to myself that I would deal with real issues that affect real people. I made a commitment to my constituents that I would be responsive to their needs and try to open up government to those people who had the least access and ability to navigate in it. One issue that was important to me was the state's workers' compensation provider. Workers' compensation insurance has a wide-reaching impact on the state's economy and State Fund's role in the workers' compensation market affects a lot of Californians.

So, when an internal review by State Fund's board of directors revealed serious concerns about its operations, it was clear to me that the organization needed a transformation. As an employer who has dealt with workers' compensation insurance in the past, I was one of few legislators who understood the front and back side of a payroll check, and that allowed me to bring a unique perspective to the legislature. And as chairman of the Senate Committee on Banking, Finance and Insurance, I had jurisdiction over the subject matter.

I believe in working with the people legislation will affect, so with the help of State Fund leaders Jeanne Cain and Jan Frank, I proposed SB 1145, a piece of legislation that would lay the legal groundwork necessary to support State Fund's operational transformation. We sought a constitutional balance that would benefit California's businesses but not be so draconian that it would negatively affect State Fund's business.

What passed was a bill that made significant changes to the laws that govern State Fund by expanding State Fund's board of directors from five political appointees to 11 and making it possible to hire and retain top-tier executive talent from the private sector. The bill also increases transparency while protecting State Fund's ability to remain competitive within the market.

What's more important, though, are the people who will benefit from this piece of legislation—the real people with real issues I promised to help when I began my career in the public sector. In addition to guaranteed availability, California's employers will see better service due to a more efficiently run company; California's workers will experience improved service because of updates to State Fund's IT infrastructure; and State Fund employees will have greater job security as a result of a more competitive State Fund.

At the time I was working on this legislation, I did not know I would later play a role in overseeing its implementation. In January of this year, I was appointed to State Fund's board of directors and I now have a fiduciary responsibility to assist State Fund's management in righting the ship and keeping it on course. State Fund is growing into the changes brought about by the legislation. We've experienced some growing pains, but we continue to improve and I think we're making positive progress.

The bottom line is that the system has gone through some evolution, but it's here to protect injured workers. Reform has allowed State Fund to reevaluate its role in the market and provide greater stability to California's businesses, employees, and injured workers, making it a vital asset and unique state resource.

"State Fund is growing into the changes brought about by the legislation. We've experienced some growing pains, but we continue to improve and I think we're making positive progress."

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MICHAEL MACHADO
CALIFORNIA STATE SENATOR (RETIRED)

DIANE WREN, A.R.M.

ENTERPRISE RISK MANAGER, COMMUNITY REDEVELOPMENT AGENCY OF THE CITY OF LOS ANGELES

As an Enterprise Risk Manager for the Community Redevelopment Agency of the City of Los Angeles (CRA/LA), I am often concerned about the health and safety of our employees, the economic challenges we face as a state and a nation, and the effect this may have on the already blighted and low-income communities we serve.

If I'm doing my job well, it eliminates the worry factor for my coworkers and allows them to focus on CRA/LA's essential functions, like funding housing and social programs in support of revitalization efforts. Every time CRA/LA funds a mixed-use or commercial project, it helps create jobs for the people of Los Angeles. The funding of these projects is significant in any economic environment, but it is particularly essential today given the current state of the economy.

I believe a good risk manager should be proactive in implementing loss control measures—you have to be when you consider the number of environmental hazards to which our employees may be exposed. In order to perform my duties to the best of my ability, I need a trusted partner in risk management and a stable provider of workers' compensation insurance. I need a carrier who speaks the same language. Someone who understands that the health and safety of our employees come first. Someone with a qualified staff that knows that it's not just about reducing claims, but also about being proactive in preventing injuries. We have been with State Fund since the creation of the CRA/LA in 1948, and we continue to benefit from many of their services.

While in a recent meeting with our State Fund representative, I coincidentally received a report that black dust particles were falling from the office ventilation system. Before I had a chance to process and respond to the report, our State Fund representative quickly began collecting samples to send to the lab for testing. Another time I called State Fund when we smelled fumes in our offices, and they had a representative here within an hour taking air samples and tests.

One of the best things about State Fund is that you don't have to ask them to do their job. They know what their job is, when to do it, and how to do it—which makes my job a lot easier. Without State Fund's expert services, I would have to hire specialists in a variety of disciplines to help me identify and mitigate potential hazards. It's not just about State Fund's subject matter experts, it's about the cost savings I receive by not having to hire those specialists myself. That cost savings means more money can be better spent on revitalizing the communities CRA/LA serves.

I judge my relationship with State Fund by how responsive they are, the quality and types of services they provide, and the expertise and demeanor of their staff. I rate State Fund A+ every time.

At the end of the day, all I want is to go home safe and healthy to my family, and to ensure that our employees go home safe and healthy to their families. State Fund has helped me do this, year after year.

"I judge my relationship with State Fund by how responsive they are, the quality and types of services they provide, and the expertise and demeanor of their staff. I rate State Fund A+ every time."

"I need a carrier who speaks the same language. Someone who understands that the health and safety of our employees come first. Someone with a qualified staff that knows that it's not just about reducing claims, but also about being proactive in preventing injuries."

DIANE WREN, A.R.M.
ENTERPRISE RISK MANAGER, COMMUNITY REDEVELOPMENT AGENCY OF THE CITY OF LOS ANGELES

HELLENE S. BRODSKY BLAKE, M.A.

TEACHER, JOURNEY SCHOOL

Before my accident, I'd never had any interaction with workers' compensation insurance. As a teacher at the kindergarten level, I need to be in the classroom and able to lead the many activities that are crucial for this age group. It takes an amazing amount of physical endurance to keep up with a roomful of kindergarteners, so it's important that I stay healthy. State Fund understood that and helped me get back to my students.

Teaching at a Waldorf-inspired public charter school means that continuity and longevity are an integral part of the curriculum. Ideally at a Waldorf-inspired charter school, the same teacher instructs the same group of students from first to eighth grade, and the kindergarten teacher works with the students for two consecutive years. For me, this means that I am nurtured by nurturing the children. I think that's an important quality to have as a teacher, because it is our job to allow a child's full capacity to unfold gradually, organically, and naturally.

Every Friday, the students and I take a walk around the school's neighboring area. The goal of our walks is for the students to connect with nature—to observe the environment over time and to create a group of caring, conscientious individuals.

On one of our walks, I felt my knee twist and I knew right away it was bad. X-rays and an MRI showed that I had torn my medial and lateral menisci. The doctor told me I needed surgery and that while I could still work, I would need to minimize movement as much as possible. That's hard to do as a kindergarten teacher. I was committed to the recovery process, but I wanted to return to my normal work routine—for my students and myself.

I was amazed at the comprehensive assistance I received from State Fund. They were encouraging and guided the recovery process, from beginning to end. One of the best things about my experience with them was that they concurred with the treatments my doctor recommended. You hear stories about insurance companies making the claims and recovery process difficult, but State Fund was supportive the entire time.

As a teacher I know how important it is to make someone feel cared for, acknowledged, and important. My experience with State Fund made me realize that those same feelings are important when you find yourself injured and anxious to return to work. State Fund understood that getting back to work and returning my students to their regular rhythm was important. They understood my needs, my students' needs, and my school's needs, and worked with me to find a solution that would work for everyone. State Fund was committed to modifying my program instead of modifying me so I could continue to teach and be there—physically, mentally, and emotionally—for my students.

During the recovery process, I wasn't able to join the students for Friday walks and many of them didn't want to go as a result. They wanted the security of knowing I was going to be there. When I was finally able to join them again, they all wanted to be my partner. That was such a lovely feeling; it was just great.

There is a stream that crosses the path on our walks and, in the past, the children would never cross over it. Recently, the kids gained enough confidence to cross the stream for the first time. Because of State Fund's commitment to helping me return to work as healthy and as quickly as possible, I was able to be there for that moment.

"State Fund understood my needs, my students' needs, and my school's needs, and worked with me to find a solution that would work for everyone. They were committed to modifying my program instead of modifying me so I could continue to teach and be there—physically, mentally, and emotionally—for my students."

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STATE FUND
BOARD OF DIRECTORS

Left to right: Vincent E. Mudd; Sen. Michael J. Machado *(Ret.)*; Sheryl A. Chalupa; Jeanne L. Cain (*Chair*); Francis E. Quinlan; Steven L. Rank; Daniel M. Curtin; John C. Duncan. Not pictured: Thomas E. Rankin.

STATE FUND EXECUTIVE OFFICERS

Left to right: Jim Neary, *Executive Vice President, Actuarial/Chief Advisor*; Carol Newman, *General Counsel*; Peter Guastamachio, *Chief Investment Officer*; Connie Raiche, *President, Claims Operations (Ret.)*; Jay Stewart, *Chief Financial Officer*; Andreas Acker, *Senior Vice President of Human Resources and Organizational Development*; Jan Frank, *President and Chief Executive Officer*; Doug Stewart, *Chief Risk Officer*; Linda Hoban, *President, Claims Operations*; Harrison Jerome, *Chief Operating Officer*; Jennifer Vargen, *Communications Director*. Not pictured: Tom Clark, *President, Policy Operations.*

FINANCIAL HIGHLIGHTS

DECEMBER 31, 2008 & 2007 (IN THOUSANDS)

	2008	2007	Percent Change
Assets	21,104,841	21,752,016	-2.98%
Premiums Earned	1,663,669	2,274,908	-26.87%
Net Investment Income	896,227	961,471	-6.79%
Losses	1,251,950	1,601,790	-21.84%
Loss Adjustment Expenses	609,735	619,585	-1.59%
Net Income	75,063	326,902	-77.04%
Policyholders' Surplus:	5,088,921	4,908,725	3.67%
Special Surplus for Retroactive Reinsurance	576,256	576,256	0.00%
Unassigned Surplus	4,512,665	4,332,469	4.16%
Premiums Earned to Policyholders' Surplus Ratio	**0.327**	**0.463**	

STATUTORY BASIS FINANCIAL STATEMENTS (WITH INDEPENDENT AUDITOR'S REPORT THEREON)

DECEMBER 31, 2008 & 2007

INDEPENDENT AUDITOR'S REPORT

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, 2008 and 2007, 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, 2008 and 2007, 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, 2008 and 2007, 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 21, 2009

KPMG provides audit, tax, and advisory services and industry insight to help organizations negotiate risks and perform in the dynamic and challenging environments in which they do business.

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

DECEMBER 31, 2008 & 2007 (IN THOUSANDS)

Admitted Assets		2008	2007
Bonds, at amortized cost	$	18,523,828	19,641,678
Real estate		378,387	346,802
Cash, cash equivalents and short-term investments		1,540,210	970,157
Receivables for securities		1,850	—
Total cash and investments		**20,444,275**	**20,958,637**
Premiums in the course of collection		43,586	55,266
Deferred, earned but unbilled and accrued retrospective premiums		49,277	70,827
Reinsurance recoverables		1,968	10,238
Accrued interest and dividends		189,929	218,140
Guaranty fund receivables		171,996	210,155
Due from adjusting contracts		65,799	63,083
Other assets		138,011	165,670
Total admitted assets	$	**21,104,841**	**21,752,016**

Liabilities and Policyholders' Surplus		2008	2007
Estimated liabilities for:			
Losses	$	14,488,903	15,064,949
Loss adjustment expenses		1,890,593	1,865,269
Retroactive reinsurance ceded		(835,871)	(952,203)
Collateral for loaned securities		—	329,377
Unearned premiums		90,659	102,604
Guaranty fund assessments liability		9,931	12,155
Amounts held in trust liability		72,188	80,025
Other liabilities		299,517	341,115
Total liabilities		**16,015,920**	**16,843,291**
Special surplus for retroactive reinsurance		576,256	576,256
Unassigned surplus		4,512,665	4,332,469
Policyholders' surplus		**5,088,921**	**4,908,725**
Total liabilities and policyholders' surplus	$	**21,104,841**	**21,752,016**

See accompanying notes to statutory basis financial statements.

STATEMENTS OF OPERATIONS IN POLICYHOLDERS' SURPLUS (STATUTORY BASIS)

YEARS ENDED DECEMBER 31, 2008 & 2007 (IN THOUSANDS)

		2008	2007
Net premiums earned	$	1,663,669	2,274,908
Losses incurred		1,251,950	1,601,790
Loss adjustment expenses incurred		609,735	619,585
Underwriting and administrative expenses		537,747	639,545
Total underwriting deductions		**2,399,432**	**2,860,920**
Net underwriting loss		**(735,763)**	**(586,012)**
Investment income		1,030,707	1,108,597
Net realized capital losses		(86,668)	(34,809)
Investment expenses		(47,812)	(112,317)
Net investment income		**896,227**	**961,471**
Loss on premiums charged off (net of recoveries)		(87,502)	(48,557)
Net income before dividends to policyholders		**72,962**	**326,902**
Dividends to policyholders		(2,101)	—
Net income		**75,063**	**326,902**
Policyholders' surplus, beginning of year		4,908,725	4,496,655
Change in nonadmitted assets		86,746	84,669
Change in net unrealized capital gains (losses)		—	(228)
Change in provision for reinsurance		18,387	727
Policyholders' surplus, end of year	$	**5,088,921**	**4,908,725**

See accompanying notes to statutory basis financial statements.

STATEMENTS OF CASH FLOWS (STATUTORY BASIS)

YEARS ENDED DECEMBER 31, 2008 & 2007 (IN THOUSANDS)

		2008	2007
Premiums collected net of reinsurance	$	1,629,874	2,280,424
Net investment income		1,046,273	1,020,654
Recoveries from premiums charged off		29,843	37,117
Benefits and loss related payments		(1,819,726)	(1,963,250)
Other underwriting expenses		(1,020,355)	(1,132,817)
Net cash provided by operations		(134,091)	242,128
Proceeds from investments sold, matured, or repaid:			
Bonds		4,946,216	4,804,246
Real estate		14,691	6,189
Short-term investments and other		(12,166)	(23,218)
Cost of investments acquired:			
Bonds		(3,935,602)	(4,825,019)
Real estate		(50,355)	(76,156)
Net cash provided by (used in) investments		962,784	(113,958)
Other cash used		(258,640)	(1,309,781)
Net cash used in financing and miscellaneous sources		(258,640)	(1,309,781)
Net change in cash, cash equivalents and short-term investments		570,053	(1,181,611)
Cash, cash equivalents and short-term investments, beginning of year		970,157	2,151,768
Cash, cash equivalents and short-term investments, end of year	$	**1,540,210**	**970,157**

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 losses 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 commissions and 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. Among 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 permitted 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 was contracted to lend State Fund's U.S. Treasury notes and bonds. When the securities were initially loaned, State Fund received cash collateral equivalent to 102% of the fair value of the securities loaned. Such cash collateral, which was unrestricted, was adjusted daily and was required at all times to equal at least 100% of the fair value of securities loaned. If additional collateral was required to maintain the 100% level, State Fund received securities as additional pledged collateral. The securities received as collateral were not permitted to be pledged or sold unless the borrower defaulted. The maximum loan term was one year. In accordance with State Fund's investment guidelines, cash collateral was invested in short-term investments with maturities matching the related loans. Interest income on these investments was shared by the borrower, the third party lending agent, and State Fund. The obligation to return collateral was reported as a separate liability entitled "Collateral for loaned securities."

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

During September 2008 State Fund terminated its Securities Lending Program and at December 31, 2008 there were no outstanding loaned securities.

(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 (MBS) are amortized using anticipated prepayments and are accounted for using the prospective method. Prepayment assumptions for MBS are obtained from the following hierarchy: Bloomberg median speed, if none then the 6-month historical constant prepayment rate (CPR), if none then the YieldBook prepayment model that runs fixed rate MBS at 100% of the model, and hybrid adjustable mortgages (ARMs) at 100% of model to balloon (MTB). Commercial MBS are run at a 0% CPR. If this information is not obtainable from one of these sources, then the analysts determine the cash flows to be used.

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

A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses, expected dividends to policyholders, and policy maintenance costs exceeds the related unearned premiums. A premium deficiency would be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. Our estimates indicate that there was no premium deficiency at December 31, 2008 and 2007. 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 1.2% and 1.4% of direct written premium for 2008 and 2007, respectively. 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 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 year 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 $12,000 and $14,000, included in the "other liabilities" account as of December 31, 2008 and 2007, respectively, 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 benefit (OPEB) plans. State Fund has no legal liability for the plans.

The State employee pension plan is administered by the Public Employees' Retirement System of the State of California (CalPERS). State Fund pays CalPERS the employers' share of its current employees' retirement cost. State Fund paid pension expense of $68,360 and $69,563 for the years ended December 31, 2008 and 2007, respectively.

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The State's OPEB plan provides medical, prescription drug, and dental benefits (healthcare benefits) to retired statewide employees. The authority for establishing and amending the OPEB plan lies with CalPERS and the State Legislature while the authority for establishing and amending the funding policy lies solely with the State Legislature. The State's OPEB plan is a single-employer defined benefit plan. A separate actuarial valuation was not performed for State Fund. The State's OPEB plan does not issue a separate report.

The State also assesses State Fund OPEB expense based upon the relative number of State Fund employees to all State employees. State Fund was assessed other postretirement benefits expense of $200,477 and $44,288 for the years ended December 31, 2008 and 2007 respectively. Pursuant to the requirements of GASB No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* the State has amended its allocation methodology to include amortization of its accumulated unfunded postretirement obligations for its year ended June 30, 2008. In August 2008, the State provided State Fund's 2007 funding requirements and its related 2007 contribution credit. In January 2009, the State provided State Fund's 2008 funding requirements and its related 2008 contribution credit. For the years ended December 31, 2008 and 2007, the annual required contributions (ARC) were $115,865 and $123,773, respectively. Of these amounts, $40,390 and $40,889 were estimated as contributed for 2008 and 2007, respectively. In accordance with State Fund accounting policies, an accrual was not required at December 31, 2007. Accordingly, after deducting the estimated contributions of $40,390 and $40,889, the remaining (ARC) balance of $158,359 was accrued as a liability as of December 31, 2008.

The State's annual OPEB cost is calculated based on the ARC of the employer, an amount actuarially determined by the State in accordance with the parameters of GASB No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years. The State determines the allocation for State Fund based upon the relationship of active retiree health benefit costs for State Fund as compared to the total State active retiree health benefit costs. The following table shows the components of State Fund's allocation of the State's 2007 and 2008 OPEB cost, the amount credited to the plan, and changes in the net OPEB obligation as of December 31, 2008:

Annual required contribution	$	239,638
Adjustment to annual required contribution		—
Annual OPEB cost		239,638
Estimated contribution credit		(81,279)
Increase in net OPEB		158,359
Net OPEB obligation beginning of year		—
Net OPEB obligation end of year	$	**158,359**

The percentage of annual OPEB costs contributed to the plan was 34% for 2008.

The ARC is defined as the Normal Cost plus a 30 year level-percent-of-pay amortization of the Unfunded Actuarial Accrued Liability.

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

All actuarial methodology, assumptions and results discussed herein were provided to State Fund by the State of California.

Based on information provided to State Fund by the State of California, in the July 1, 2007 actuarial valuation, the individual entry-age normal cost method was used. A pay-as-you go funding scenario was used by the State of California. Under the pay-as-you go funding scenario, the State is assumed to finance retiree healthcare benefits from assets available in the general fund. The State's actuarial assumptions included a discount rate of 4.5%, and an annual healthcare cost trend rate of 10% initially, decreasing each year over the next nine years until the ultimate rate of 4.5% is reached.

Funding progress information specifically related to State Fund's portion of the statewide OPEB plan is not available. For more details about the actuarial methods and assumptions used by the State as well as the statewide plans funding progress and status, refer to the State of California's Comprehensive Annual Financial Report (CAFR) for the fiscal year ended 2008.

(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 2007 to conform to the 2008 presentation.

(m) *Recently Adopted Accounting Standard*

Effective January 1, 2009, the Company adopted Statutory of Accounting Principles No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments*, an Amendment of SSAP No. 43 – Loan-backed and Structured Securities (SSAP No. 98). SSAP No.

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98 creates a two-step process for determining whether an other-than-temporary impairment has occurred for loan-backed and structured securities. First, impairments are identified and measured by comparing each security's fair value to its amortized cost. Second, identified impairments are evaluated as temporary or other-than-temporary considering the guidance in Interpretation No. 06 07, *Definition of Phrase 'Other-Than-Temporary'*. Under SSAP No. 43, Loan-backed and Structured Securities, other-than-temporary impairments in loan-backed or structured securities were considered to have occurred only when their undiscounted estimated future cash flows are less than their current book value. Changes resulting from the adoption of SSAP No. 98 will be accounted for prospectively. The Company's adoption of SSAP No. 98 is not expected to have a material impact on the Company's statutory financial statements.

(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, 2008, 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, 2008 and 2007 are as follows:

		2008			
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury securities and U.S. government sponsored enterprise securities	$	3,341,705	325,642	—	3,667,347
Obligations of states and political subdivisions		388,604	11,759	(8,697)	391,666
Public utilities		460,102	4,096	(7,104)	457,094
Corporate debt securities		5,218,698	58,382	(165,787)	5,111,293
Special revenue		1,236,851	12,862	(44,266)	1,205,447
Mortgage-backed securities		7,877,868	220,120	(6,996)	8,090,992
Totals	$	**18,523,828**	**632,861**	**(232,850)**	**18,923,839**

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		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**

State Fund's mortgage-backed holdings as of December 31, 2008 and 2007 consist solely of securities issued by FNMA, GNMA and FHLMC, as follows:

		2008			
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
FNMA	$	3,019,164	75,848	(4,295)	3,090,717
GNMA		1,728,037	61,328	—	1,789,365
FHLMC		3,130,667	82,944	(2,701)	3,210,910
Totals	$	**7,877,868**	**220,120**	**(6,996)**	**8,090,992**
		2007			
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**

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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, 2008 and 2007, 343 and 569 securities were in an unrealized loss position, which resulted in an unrealized loss of $232,850 and $126,552, respectively. State Fund management believes the unrealized loss position at the end of 2007 was due to changes in market interest rates and not due to a material decline in credit quality of State Fund's portfolio holdings, while the unrealized loss position at the end of 2008 was due primarily to the financial crisis that began in September, 2008. 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, 2008, 99.37% of all bonds held by State Fund were rated by the NAIC. State Fund concluded that the gross unrealized losses of $232,850 as of December 31, 2008 were temporary in nature.

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2008 and 2007.

		2008					
		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	$	—	—	—	—	—	—
Obligations of states and political subdivisions		123,661	(4,702)	44,799	(3,995)	168,460	(8,697)
Public utilities		151,197	(2,480)	62,218	(4,625)	213,415	(7,105)
Corporate debt securities		2,257,293	(86,144)	744,062	(79,643)	3,001,355	(165,787)
Special revenue		535,404	(24,480)	141,246	(19,786)	676,650	(44,266)
Mortgage-backed securities		67,695	(1,632)	133,215	(5,363)	200,910	(6,995)
Totals	$	**3,135,250**	**(119,438)**	**1,125,540**	**(113,412)**	**4,260,790**	**(232,850)**

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		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)**

The amortized cost and estimated fair value of bonds as of December 31, 2008, 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.

		2008	
		Amortized value	Estimated fair value
Due in one year or less	$	1,610,347	1,620,822
Due after one year through five years		4,469,504	4,570,951
Due after five years through ten years		3,915,662	4,032,976
Due after ten years		650,447	608,099
Mortgage-backed securities		7,877,868	8,090,991
Totals	$	**18,523,828**	**18,923,839**

Proceeds from sales and redemptions of investments in bonds during 2008 were $4,946,216 with gross realized gains of $44,262 and gross realized losses of $21,297. 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.

For the year ended December 31, 2008, State Fund recognized a total of $101,594 other-than-temporary impairment in bonds, primarily due to Lehman Brothers Holdings.

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 $68,753 and $55,376 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, 2008 and 2007, respectively.

There were not loaned securities as of December 31, 2008. The aggregate fair value of loaned securities was $333,957 as of December 31, 2007, while the cash collateral received in respect to these loans was $329,377. For 2007, additional noncash collateral of $7,011 which is restricted, was received in the form of U.S. Treasuries. The fair value of the reinvested cash collateral was $306,984 as of December 31, 2007. State Fund terminated its Securities Lending Program in September 2008.

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 defaulted on its commercial paper obligations in August 2007. At December 31, 2008 and 2007, the investment was written down to an estimated fair value of $0 and $25,000, respectively. For the years ended December 31, 2008 and 2007, State Fund recognized other-than-temporary impairments which were included in net realized capital losses from the investment of $12,926 and $24,355, respectively. 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.

State Fund does not engage in subprime residential mortgage lending. As of December 31, 2008, State Fund has no direct subprime mortgage related risk exposure.

State Fund as well as other State Agencies and Local Agencies are authorized to invest funds in the State of California's Pooled Money Investment Account (PMIA). State Fund's holdings in the PMIA at December 31, 2008 were $1.4 billion and represent 2.24% of the total $63.3 billion balance in the State of California's Pooled Money Investment Account. Investments in the PMIA at December 31, 2008 included the following: 34% in Loans; 24% in Agencies; 18% in U.S. Treasuries; 13% in Collateralized Time Deposits; 6% in Certificates of Deposit and Bank Notes; 3% in Commercial Paper; 2% in Mortgages and less than 1% in Corporate Bonds.

DECEMBER 31, 2008 & 2007 (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. As of May 9, 2008 the State Fund Board of Directors amended the State Fund's investment policy to preclude any new purchases of corporate debt securities and the holding of corporate debt in its money market funds.

(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, 2008 and 2007 is comprised of the following:

		2008	2007
Property occupied by the company	$	457,531	327,585
Property held for sale		—	10,016
Construction in progress		—	80,138
		457,531	417,739
Accumulated depreciation		(79,144)	(70,937)
Totals	$	**378,387**	**346,802**

Furniture and equipment as of December 31, 2008 and 2007 is comprised of the following:

		2008	2007
Data processing equipment and software	$	108,485	106,909
Office furniture and equipment		152,523	136,384
		261,008	243,293
Accumulated depreciation		(210,913)	(175,320)
		50,095	67,973
Less nonadmitted assets		(48,449)	(65,719)
Totals	$	**1,646**	**2,254**

DECEMBER 31, 2008 & 2007 (DOLLAR AMOUNTS IN THOUSANDS)

Depreciation expense on real estate was $8,208 and $5,395 for the years ended December 31, 2008 and 2007, respectively. Depreciation expense on furniture and equipment was $35,593 and $34,846 for the years ended December 31, 2008 and 2007, 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.

(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, 2008 and 2007. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of a loss portfolio transfer.

		2008	2007
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of $243,723 and $235,188, respectively	$	16,930,218	17,275,775
Add incurred related to:			
Current year		1,510,513	1,955,657
Prior years		351,172	265,718
Total incurred		1,861,685	2,221,375
Less paid related to:			
Current year		181,982	207,865
Prior years		2,230,425	2,359,067
Total paid		2,412,407	2,566,932
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of $247,767 and $243,723, respectively	$	**16,379,496**	**16,930,218**

Incurred losses and loss adjustment expenses relating to insured events in prior years were approximately $351,172 and $265,718 in 2008 and 2007, respectively. Increases to prior year incurred are attributable to the strengthening of loss adjustment expense reserves. The loss adjustment expenses strengthening in 2008 was in part related to GASB 45 requiring State Fund recognition of an additional annual required contribution for State Fund employees' Post Employment Health Benefits, $110,162 of which was allocated to LAE.

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.

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.

DECEMBER 31, 2008 & 2007 (DOLLAR AMOUNTS IN THOUSANDS)

State Fund requires the insurance companies that underwrite structured settlement annuities to have an A.M. Best credit rating of A+ or better and $8 billion dollars or more in total assets at the time of purchase. The total amount of loss reserves no longer carried due to the purchase of annuities, with the claimant as payee, was $471,571 and $354,272 as of December 31, 2008 and 2007, 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 Policyholders' Surplus as of December 31, 2008 and 2007:

		2008	2007
Genworth Financial	$	100,460	108,206
Hartford Life Insurance		100,859	83,846
Aviva Life Insurance Company		100,163	74,091
Totals	$	**301,482**	**266,143**

(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 2008 by per occurrence excess of loss reinsurance treaties for $1,050,000 of losses excess of $300,000 for a catastrophe involving 30 or more claimants. The treaty provided one reinstatement at 100% of premium as to time, pro-rata as to amount. As respects a terrorist incident, State Fund was covered in 2008 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 $177,952 of coverage excess of a $300,000 retention on an aggregate annual basis. Above $477,952 TRIA provided coverage for 85% of losses related to certified acts of international terrorism having a minimum industry aggregate impact in excess of $100,000. Private reinsurance provided coverage in the 15% TRIA coinsurance corridor up to a limit of $272,048.

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 per layer on a 100% of premium basis as to time, pro-rata 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 $200,000 retention on an aggregate annual basis. Above $716,364 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 $716,364.

For the years ended December 31, 2008 and 2007, total earned premiums ceded under the reinsurance contracts were $58,742 and $114,850, respectively.

Based upon the estimated reinsurance recoverable under prior reinsurance treaties, State Fund's liabilities for losses were reduced by $247,767 and $243,723 as of December 31, 2008 and 2007, respectively, including $75,825 and $59,961 recoverable from Munich Re America Reinsurance Co. and Reliastar Life Insurance Co., respectively, as of December 31, 2008, and $87,796 and $62,539 as of December 31, 2007, respectively. State Fund commuted reinsurance recoverables of $10,545 and wrote off reinsurance balances due of $143 as of December 31, 2007. There were no commutations and write offs as of December 31. 2008.

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 2007 and 2008.

DECEMBER 31, 2008 & 2007 (DOLLAR AMOUNTS IN THOUSANDS)

As of December 31, 2008 and 2007, cumulative subject paid losses were $1,471,254 and $1,341,997, respectively, which exceeded the $950,000 retention. These netted to a total receivable of $469,129 and $352,797 from the Reinsurers (after State Fund's 10% retention) as of December 31, 2008 and 2007, respectively, of which $441,844 and $323,133 were collected from the Reinsurers as of December 31, 2008 and 2007, respectively. Total net receivables from the Reinsurers were $27,284 and $29,664 as of December 31, 2008 and 2007, 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 2008 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.

(9) Commitments and Contingencies

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

The aggregate minimum annual lease payments under such operating leases as of December 31, 2008 were as follows:

Year	2009	$	39,373
	2010		28,542
	2011		17,978
	2012		14,472
	2013		9,793
	Thereafter		6,844
	Total	$	**117,002**

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, 2008 and 2007, the total rental expense for office space was $63,863 and $66,000, respectively, which included an allocation of rental value to space owned and occupied by State Fund of $35,540 and $32,022, respectively. Vehicle and other lease expenses were $20,940 and $30,726 for the years ended December 31, 2008 and 2007, respectively.

In the normal course of business, State Fund is subject to various claims and litigation. Additionally, State Fund was a defendant in five 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 balances for medical bills paid below the Official Medical Fee Schedule's rate of reimbursement, the fourth case asserts a claim on behalf of all policyholders who were allegedly damaged by State Fund's failure to disclose that premiums for future policies might increase when a policyholder changed a policy inception date with an individual policy to a group policy and the fifth case, currently on appeal, was filed on behalf of California attorneys and seeks interest on awards by the Workers' Compensation Appeals Board of attorneys fees for services provided to injured workers. 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. There were no such payments made in 2008. Refer to footnote 2(i) regarding State Fund's agreement with the State of California Department of Personnel Administration.

(11) Other Matters

As of January 1, 2007, State Fund is subject to the Bureau of State Audit jurisdiction with broad oversight and audit authority.

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 which 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 California Department of Insurance, 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 second phase of CDI's operational audit is complete. CDI officially released its report in May 2009. Its findings indicate significant improvements.

As of the issuance of these financial statements, State Fund management has no indication of any findings or recommendations which would adversely impact these financial statements.

(12) Risks and Uncertainties

The economies of California, the United States and the world are experiencing a deepening recession. There has been a rise in the unemployment rate and significant disruption in the capital markets. While some economists have predicted an end to this recession by sometime in the second half of 2009, the actual length and depth of the recession and the disruption in the capital markets is currently unknown.

The Company is affected by the recession, particularly in how it impacts the state of California. The deepening recession with rising unemployment has contributed to declining premium revenues and could lead to further premium revenue declines in the future. The disruption in the capital markets has led to reductions in the fair value of the Company's investments which led to significant capital losses in 2008. Should the capital markets continue to be strained, it is likely that further capital losses will be realized.

The Company is taking steps to align expenses with declining revenues, however, not all expenses can be effectively reduced and continued declines in premium volumes could lead to higher expense ratios.

The impact on the Company from the recession would also affect the net income and surplus.

On February 3, 2009, the Workers' Compensation Appeals Board (WCAB) issued two en banc decisions, one describing specific ways to challenge the diminished future earning capacity (DFEC) component of the 2005 Permanent Disability Rating Schedule (PDRS) [*Ogilvie v. City and County of San Francisco*] and the other challenging the AMA Guides to dictate permanent disability ratings, [*Almaraz v. SCIF and Guzman v. Milpitas USD*]. The position of the Appeals Board is that these decisions are binding on all Appeals Board panels and Workers' Compensation Judges. These decisions affect the 2004 reforms that intended to promote consistency, uniformity and objectivity into the permanent disability rating schedule. Applicant's attorneys may now rebut both the whole person impairment listed within the AMA Guides (*Almaraz/Guzman*), and/or the DFEC modifier of the 2005 schedule (*Ogilvie*). The decisions apply to all open claims that are to be rated under the 2005 PDRS and may result in more expensive permanent disability awards to injured employees, as well as significant increases in litigation costs. These en banc decisions have driven the value of permanent disability awards upward in some selected cases, however on April 6, 2009 the WCAB agreed to reconsider its findings with a decision expected in July 2009. State Fund does not know how these decisions will affect our loss costs trends or our reserves and will continue to monitor these decisions and their impact on our results.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES

DECEMBER 31, 2008 (DOLLAR AMOUNTS IN THOUSANDS)

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

At end of each quarter		
Unaudited		
1st Qtr.	2nd Qtr.	3rd Qtr.
$169,397	$47,923	—

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES *continued*

DECEMBER 31, 2008 (DOLLAR AMOUNTS IN THOUSANDS)

State Fund had no investments subject to securities lending agreements as of December 31, 2008. State Fund had the following invested assets as of December 31, 2008:

		Gross investments holdings		Admitted assets as reported in the annual statement	
		Amount (in thousands)	Percentage	Amount (in thousands)	Percentage
Bonds:					
U.S. treasury securities	$	2,188,250	10.7%	2,188,250	10.7%
U.S. government agency obligations (excluding mortgage-backed securities):					
Issued by U.S. government agencies		—	—	—	—
Issued by U.S. government sponsored agencies		1,153,455	5.6	1,153,455	5.6
Foreign government (including Canada)		—	—	—	—
Securities issued by states, territories and possessions, and political subdivisions in the U.S.:					
States, territories, and possessions general obligations		271,065	1.3	271,065	1.3
Political subdivisions of U.S. State, territories, and possessions general obligations		117,539	0.6	117,539	0.6
Revenue and assessment obligations		1,236,851	6.0	1,236,851	6.0
Mortgage-backed securities (includes residential and commercial MBS):					
Pass-through securities:					
Issued or guaranteed by GNMA		1,728,038	8.5	1,728,038	8.5
Issued or guaranteed by FNMA and FHLMC		4,710,990	23.0	4,710,990	23.0
CMOs and REMICs:					
Issued or guaranteed by FNMA, FHLMC, GNMA or VA		1,438,840	7.0	1,438,840	7.0
All other		—	—	—	—
Other debt and other fixed income securities (excluding short-term):					
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)		5,678,800	27.8	5,678,800	27.8
Unaffiliated foerign securities		—	—	—	
Real estate investments:					
Property occupied by the company		378,387	1.9	378,387	1.9
Property held for sale		—	—	—	—
Receivable for Securities:		1,850	0.1	1,850	0.1
Cash, cash equivalents and short-term investments		1,540,210	7.5	1,540,210	7.5
Total cash and investments	$	**20,444,275**	**100.0%**	**20,444,275**	**100.0%**

See accompanying independent auditor's report.

SUPPLEMENTAL INVESTMENT RISK INTERROGATORIES

DECEMBER 31, 2008 (DOLLAR AMOUNTS IN THOUSANDS)

State Fund's total admitted assets as filed in the 2008 Annual Statement is: **$21,104,841**

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
Bank of America Corp.	Industrial & Miscellaneous	$	142,523	0.7%
Wells Fargo Bank NA	Industrial & Miscellaneous		140,506	0.7
United Technologies Corp.	Industrial & Miscellaneous		140,247	0.7
JPMorgan Chase & Co.	Industrial & Miscellaneous		139,987	0.7
Honeywell International	Industrial & Miscellaneous		132,349	0.6
IBM International Group Capital	Industrial & Miscellaneous		131,545	0.6
US Bank NA	Industrial & Miscellaneous		131,514	0.6
Cisco Systems, Inc.	Industrial & Miscellaneous		130,530	0.6
John Deere Capital Corp.	Industrial & Miscellaneous		130,200	0.6
Boeing Co.	Industrial & Miscellaneous		124,147	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	$	18,612,535	88.2%
NAIC – 2		108,504	0.5
NAIC – 3		—	—
NAIC – 4		—	—
NAIC – 5		—	—
NAIC – 6		8,925	—

State Fund does not have any preferred stocks.
State Fund does not hold any foreign investments.
State Fund's Canadian investments is less than 2.5% of the total admitted assets.
State Fund's real estate is less than 2.5% of the total admitted assets.

See accompanying independent auditor's 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 noncancelable by State Fund during the contract term;

(b) A limited or conditional cancellation provision under which cancellation triggers an obligation by State Fund, or an affiliate of State Fund, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

(c) Aggregate stop loss reinsurance coverage;

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

(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 auditor's report.

STATE FUND LOCATIONS

State Fund Home Office

1275 Market Street
San Francisco, CA 94103
(415) 565-1234

Regional Offices

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

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

Bay Area Policy Services
5880 Owens Drive
Pleasanton, CA 94588
(925) 523-5100

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

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

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

Inland Empire Policy Services
375 W. Hospitality Lane
San Bernardino, CA 92408
(909) 384-4560

Los Angeles
Glendale Claims Services
655 N. Central Avenue #200
Glendale, CA 91203
(818) 291-7000

Los Angeles
Monterey Park Policy Services
900 Corporate Center Drive
Monterey Park, CA 91754
(323) 266-5000

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

Orange County Policy Services
1750 E. Fourth Street, 8th Floor
Santa Ana, CA 92705
(714) 565-5995

Oxnard
2901 N. Ventura Road
Oxnard, CA 93036
(805) 988-5300

Redding
2175 Shasta View Drive
Redding, CA 96003
(530) 223-7000

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

San Diego
10105 Pacific Heights Blvd. #400
San Diego, CA 92121
(858) 552-7000

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

Santa Rosa
1450 Neotomas Avenue
Santa Rosa, CA 95405
(707) 573-6300

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

State Contract Offices

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

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

Riverside
6301 Day Street #200
Riverside, CA 92507
(951) 697-7300

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

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

Group Insurance

Los Angeles
900 Corporate Center, 4th Floor
Monterey Park, CA 91754
(800) 252-0419

Pleasanton
5860 Owens Drive
Pleasanton, CA 94588
(800) 533-6868

Sacramento
2300 River Plaza Drive #150
Sacramento, CA 95833
(800) 423-0303

Special Programs

Alternative Dispute Resolution–
Northern California
2275 Gateway Oaks Drive
Sacramento, CA 95833
(866) 383-6920

Alternative Dispute Resolution–
Southern California
900 Corporate Center Drive
Monterey Park, CA 91754
(866) 383-6920

Customer Service Center
Toll-Free Number:
(877) 405-4545

24-Hour Claims Reporting Center
Toll-Free Number:
(888) 222-3211

Special Investigation Unit
(888) 786-7372 (hotline)

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