STATE COMPENSATION INSURANCE FUND

on the job

2009 ANNUAL REPORT

STATE FUND BOARD OF DIRECTORS:

Jeanne Cain, Chair

Sheryl Chalupa

Francis Quinlan

Daniel M. Curtin

Sen. Michael J. Machado (Ret.), Senate Designee

Tom Rankin, Assembly Designee

Don Garcia

Lawrence Mulryan

Steve Rank

James Richardson

William Zachry

(Ex Officio Member)
John Duncan

STATE FUND EXECUTIVE COMMITTEE:

Interim President/Chief Executive Officer
Doug Stewart

General Counsel
Carol Newman

Chief Information Officer
Shaun Coyne

Chief Investment Officer
Peter A. Guastamachio

Chief Financial Officer
Jay Stewart

Chief Operating Officer
Harrison Jerome

Executive Vice President
Actuarial/Chief Advisor
Jim Neary

President/Claims Operations
Linda Hoban

President/Field Operations
Tom Clark

Senior Vice President
Human Resources and
Organizational Development
Andreas Acker

Communications Director
Jennifer Vargen

Upon completion of a national search for a President and CEO, the State Fund Board of Directors appointed Tom Rowe, effective August 2, 2010.

STATEMENT BY TOM ROWE:

I commend Doug Stewart and everyone at State Fund for being on the job for California. I have worked in the property casualty business my entire career, and I believe that State Fund represents what is best about this industry. I am passionate about our mission and will ensure State Fund continues to provide employers with a strong and stable choice for their workers' compensation insurance while making California's workplaces safer and helping injured employees return to work—without financial obligation from the public.

Tom Rowe
President and CEO

Content

2009 ANNUAL REPORT

Message

FROM THE INTERIM PRESIDENT

State Fund recorded strong financial results in 2009, yet there can be no question that it was a challenging year—for us, for the state, and for the country. California's economy, like the nation's, is recovering from the recession more slowly than all of us would like. Still, we believe that recovery is under way—and by making business possible for tens of thousands of California's businesses, State Fund is on the job for California. That is why this annual report features State Fund employees and the important ways they are on the job—helping to make California work. They demonstrate State Fund's ongoing commitment to California's businesses and workers.

Given the economic challenges we face, I am pleased to report that State Fund's financial position remains rock solid. We recorded net income of $143 million for 2009, up from $75 million for the prior year. This net income allowed us to add $161 million to policyholders' surplus, further strengthening our ability to meet our future financial commitments. We also managed to strengthen our balance sheet and capital base through solid investment returns. At 2009 year-end, 99.8 percent of our investment portfolio was rated NAIC 1, the highest rating that the National Association of Insurance Commissioners gives to investments.

State Fund maintained a 75.3 percent loss ratio, identical with the prior year. This translated to $940 million of incurred loss in 2009 versus $1.3 billion the prior year. We also lowered underwriting expenses to $456 million, down from $538 million in 2008.

While we are pleased with these results, our loss adjustment expense (LAE) ratio (defined as loss adjustment

expenses divided by written premium) remains a longer-term challenge. Even though our real loss adjustment expenses declined in 2009, our LAE ratio increased about ten points to 46 percent. This contributed to a 2009 combined ratio (defined as the sum of loss and expense ratios divided by written premium) of 161.5 percent. Our LAE challenge is related to a large inventory of open claims dating from 2001 to 2004. This is when California's workers' compensation insurance market was in crisis after many carriers either became insolvent or left the market. During that time State Fund shouldered an unusually high market share to ensure California's businesses and injured workers would be covered. Although these ratios are well above industry benchmarks, we expect them to come down over the next few years as we bring many of the older claims to resolution.

State Fund also faces challenges that are common throughout the industry in California. Premiums are falling across the board due to lower employment numbers, and medical costs are rising. However, we are confident that our expertise and commitment to services will position us as the continued industry leader as this recovery takes hold.

State Fund employees are on the job for all Californians in some very significant ways. They maintain our open-door policy for writing business. They help clients establish accurate payroll reporting so they can pay their premium scaled to actual costs. And our employees help Californians injured on the job heal and return to work as quickly as possible. This report features five such employees who are on the job for State Fund and California along with a satisfied customer:

- Bilingual loss control consultant Pedro Acero of Oxnard and Paul Wenger of the Farm Bureau.
- Return to work coordinator Debra Mejia and injured worker Frank Rosencutter.
- Special Investigation Unit investigator Phillis Shorts and Deputy District Attorney for San Diego County Dominic Dugo.
- Underwriter Carrie Burt and broker Michael Moore.
- Auditor Shirlene Spaulding and policyholder Kevin Giossi.

As we look to the future, we look to keep the commitment we made to California almost a hundred years ago. We will continue to improve our operations and strengthen our financial position. We will be the partner businesses and workers depend on to keep California on the job.

Doug Stewart

Doug Stewart, CPCU
Interim President and CEO





Protecting California's Most Important Resource

PEDRO ACERO

is a State Fund loss control consultant with more than 20 years of experience, assessing workplace risk, developing safety programs, and leading safety training seminars—in both English and Spanish—for a wide variety of clients in Ventura, Santa Barbara, and San Luis Obispo counties.

"When I started with State Fund, I was concerned by statistics showing agricultural workers at high risk for on-the-job injuries. Many of these workers spoke only Spanish, and I realized bilingual safety education was an area in which I could really make a difference.

"Drawing from my background in teaching and my loss control expertise, I developed a program to address agricultural safety issues. I created and delivered bilingual programs on pesticide safety, tractor safety, ergonomics, and preventing heat illness. It became my passion.

"Heat illness is a major problem for farm workers, especially in high-temperature areas like the Coachella Valley. I conduct heat illness prevention seminars regularly in English and Spanish for our Farm Bureau clients. It is especially satisfying to be able to offer this and other safety seminars in Spanish—otherwise many Spanish-speaking workers might be left out.

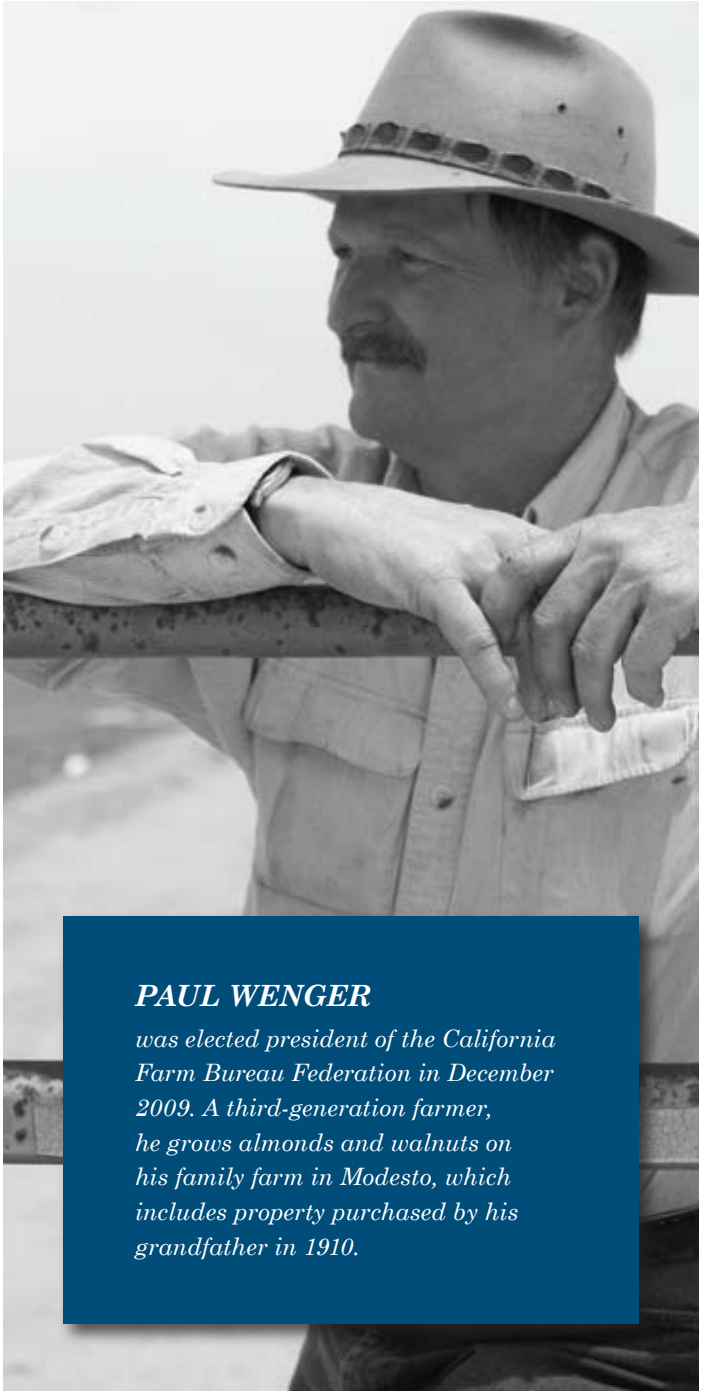
"These seminars are one way I can help employers and workers stay safe. We must put maximum effort into protecting our workers, because they're not statistics—they're human beings."

"I've always felt pretty strongly that you support the people who support you. And for many years I've seen firsthand that the field reps from State Fund who have worked with the Farm Bureau have been great advocates for agriculture and strong supporters of our industry.

"State Fund is a leader in improving worker safety for our Farm Bureau members. Their loss control reps are accessible, attentive, and always on the front line to find out what's going on in the field. They're helping prevent injuries and keep what could be a very dangerous work environment safe. Whether it's heat illness, pesticide safety, or tractor safety, there are always those issues out there, and State Fund has always been a willing partner to make sure we have a safe working environment.

"Offering safety seminars in Spanish is a valuable benefit State Fund provides our members. Some of our folks are bilingual already, but many only speak Spanish. So having an expert like Pedro Acero—who knows the language and culture of the agricultural workforce—present the safety seminars in Spanish is extremely effective.

"I think most farmers at the end of the day are looking for a partner who is going to be there through thick and thin—who is going to be responsible. State Fund has definitely been that partner for us, and a valuable friend."



PAUL WENGER

was elected president of the California Farm Bureau Federation in December 2009. A third-generation farmer, he grows almonds and walnuts on his family farm in Modesto, which includes property purchased by his grandfather in 1910.

Easing the Return to Work

"With my background—Marine Corps, working in the oil fields, working for title and escrow people, working in the banking and S&L industry—I can kind of tell when someone's giving me the runaround.

"But with Debra, her help came from the heart. She did the best job somebody could do. She answered my questions and explained all the nuances. I didn't like some of her answers, but that's the workers' comp system and she was always truthful.

"I asked, 'What happens if I get hurt again? What if I refuse to lift something?' She laid it on the line. She was very empowering and gave me what I needed to know to make the hard decisions.

FRANK ROSENCUTTER
is a 62-year-old project manager for a construction materials company. In 2008, while loading heavy equipment, he suffered a torn rotator cuff. Two surgeries later, and with State Fund's help, he's back on the job.

"There are probably thousands of other people who get hurt on the job who have to protect their jobs—especially in my age group where you have no choice. You've got bills to pay, kids in college, car payments, a mortgage—you have to work.

"But thank God for Debra. She calmed me down, gave me the answers I needed, and gave me the road map. It was up to me to follow it, to go right or left. I'm glad I took her path. I know, too, that I can call her and she'll get back to me right away. And I know that she'll tell me straight up what is *is*, and what ain't *ain't*."

DEBRA MEJIA

Return to work coordinator Debra Mejia has worked at State Fund for 19 years. A typically busy day on the job includes assisting injured employees return to work as soon as possible, educating employers on the benefits of return to work and helping them customize Return to Work (RTW) programs, and talking to physicians about making RTW an important component of their treatment plans.

"Studies show that the earlier an injured employee returns to work, the better and faster their recovery—instead of sitting at home deconditioning, when all sorts of secondary complications ensue, financially and emotionally.

"Return to work is beneficial for the employer, as well. I've seen nothing better to control workers' compensation costs than a return to work program. Additionally, it empowers employers to understand their rights and responsibilities. A return to work program sends the message to all staff that they care about you; if you get hurt, you'll have a job to come back to—as soon as possible.

"I love being able to personalize a system that can be very complex. And I love taking it from a place where it's just this big, impersonal insurance company to a place where it's very personal. People associate the name and the face; there is a person who really cares.

"I first met with Frank Rosencutter when he was having issues getting back on the job after a workplace injury. He was under various pressures and had some confusion about the return to work process. So immediately, I wanted him to feel comfortable and to relieve some of that pressure, give him the opportunity to voice his concerns, and present him with all the information he needed to make informed decisions about his future. I also explained to his employer that Frank's work restrictions were to be strictly adhered to, and communicated with his physician to ensure that he could return to work safely.

"Working with Frank has been quite rewarding. He's been in a difficult situation. And in spite of all the challenges he's had in returning to work, his work ethic has been amazing. He's absolutely committed, and that's very inspiring to me."

Fighting Fraud Side by Side

"Workers' comp fraud has been called a 'victimless crime,' but I totally disagree. Fraud affects employers, employees, medical providers, insurance carriers, and ultimately every California consumer, who ends up paying more for goods and services than they should.

"I've referred about 140 fraud cases to the San Diego District Attorney's Office. Generally, for reporting purposes, when we refer a case to law enforcement for prosecution, we have to make sure there's a lie. 'No lie, no fraud.' That's the meat of the fraud statute. We then present our case to the DA's office and advise them on the nature of the fraud, how we came to that conclusion, and what evidence we have to support it.

PHILLIS SHORTS

A State Fund employee since 1987, Phillis Shorts works for the Special Investigation Unit as a senior investigator of workers' compensation fraud. Her duties include investigating claims, legal, and policy files to identify suspected fraud; coordinating the investigations of cases being referred for possible prosecution; and providing antifraud training to policyholders, law enforcement, and State Fund employees.

"If we're doing our job correctly, making sure that we have all the evidence, most of those cases should end up with somebody pleading guilty. And in an overwhelming majority of the cases, that's exactly what happens.

"I have worked with Dominic Dugo since 1999. He is as passionate about his job as I am about mine, which makes working together easy and pleasant. Mutual trust and credibility are key to our relationship. By presenting him with cases that are completely documented, clearly marked and labeled, and concisely summarized, I make his job considerably easier.

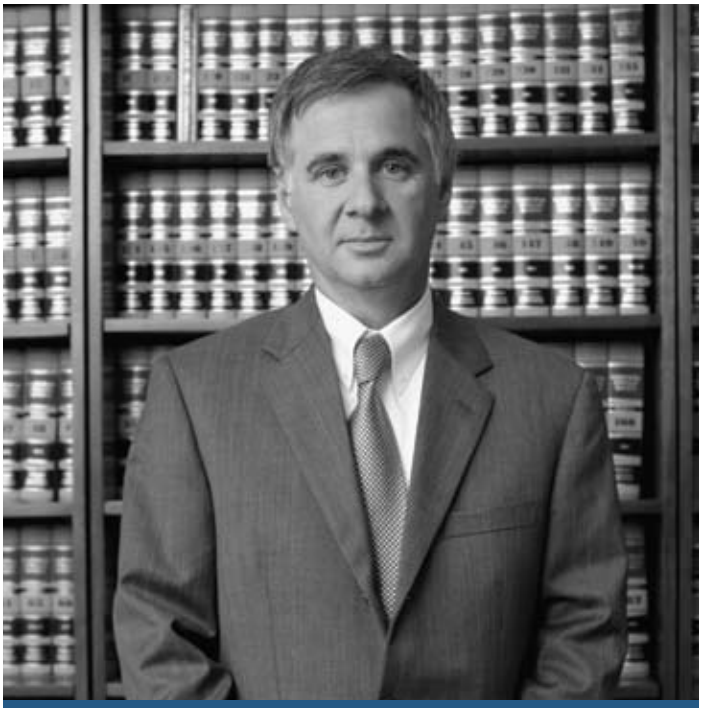
"It's reassuring to know that California law enforcement is strongly interested in pursuing violators of workers' comp fraud. With State Fund increasing the awareness of such violations—establishing more effective investigation techniques and building our antifraud training and outreach programs—we're creating a better business climate for California."

"When people think of workers' comp fraud, they typically think of a worker faking an injury. But in reality, that's a small percentage of the cases we handle. We also investigate employers lying about their payroll, employers that fail to buy workers' comp insurance at all, and medical providers who fraudulently bill for services never provided.

"I've worked with State Fund since the early 1990s. They were instrumental in helping our office create a Premium Fraud Task Force, the first one of its kind in the nation. It's been extremely effective; hundreds of cases have been prosecuted successfully through it.

"I first met Phillis Shorts in 1999 when she brought in a complex workers' comp fraud case to prosecute. We immediately developed an excellent working relationship. I know that when Phillis informs me about a case, it's accurate, thoroughly researched, and well thought-out. Her reputation is excellent, she understands the business, and I trust that what she tells me is the truth. That's critical; credibility is quite important. And it's not just Phillis—all the State Fund employees we work with on fraud investigation are outstanding.

"By reducing fraud and abuse in the workers' comp system, we can make sure injured workers receive the benefits they are entitled to under the law, and that employers have a level playing field to compete for business. This ultimately leads to lower workers' comp rates for employers and a reduction in the cost of goods and services for consumers.



DOMINIC DUGO

has been a prosecutor in the San Diego County District Attorney's Office for 24 years. He has served as Assistant Chief and Chief of the Insurance Fraud Division, and is currently Director of Fraud Grants. In 1999 he was named Insurance Fraud Prosecutor of the Year by the International Association of Special Investigation Units, Southern California Chapter.

"State Fund does an outstanding job in their antifraud efforts. They're the major carrier we work with, and of all the carriers, responsible for the largest number of fraud cases we prosecute."

Underwriting the California Dream

CARRIE BURT

Senior underwriter Carrie Burt has been with State Fund for 19 years. She underwrites new business, prepares quotes, reviews newly written policies for quality assurance, and, with her vast wisdom, serves as a training resource for her department.

"I've developed a great relationship with all my client brokerages over the years—through phone and e-mail contact, in person at broker functions, and in training seminars and classes. It's important that they see me, get to know me, and trust me.

"I began working with Michael Moore when one of our underwriters retired and I was assigned to take over his accounts. I love working with Michael. He's very accessible and open to conversations to help me better understand his clients and their unique risks.

"From everything brokers constantly tell me, which I like to brag about, we are very easy to work with, and we know what we're doing. I've even had brokers call me with general workers' comp questions when it wasn't a State Fund policy. I'm happy to help.

"In the underwriter-broker relationship, trust is vital. If a broker doesn't trust me or have faith in my ability, they're going to be hesitant to bring us business. That's why I always try to make myself available when they call, return calls promptly, and provide concise, accurate information to the best of my ability. I never, ever tell them what they want to hear just because it's what they want to hear.

"We may not always have the lowest price, but brokers know that we price our accounts responsibly. We have a long-term commitment to California and we have to be sure we will be able to pay claims into the future."

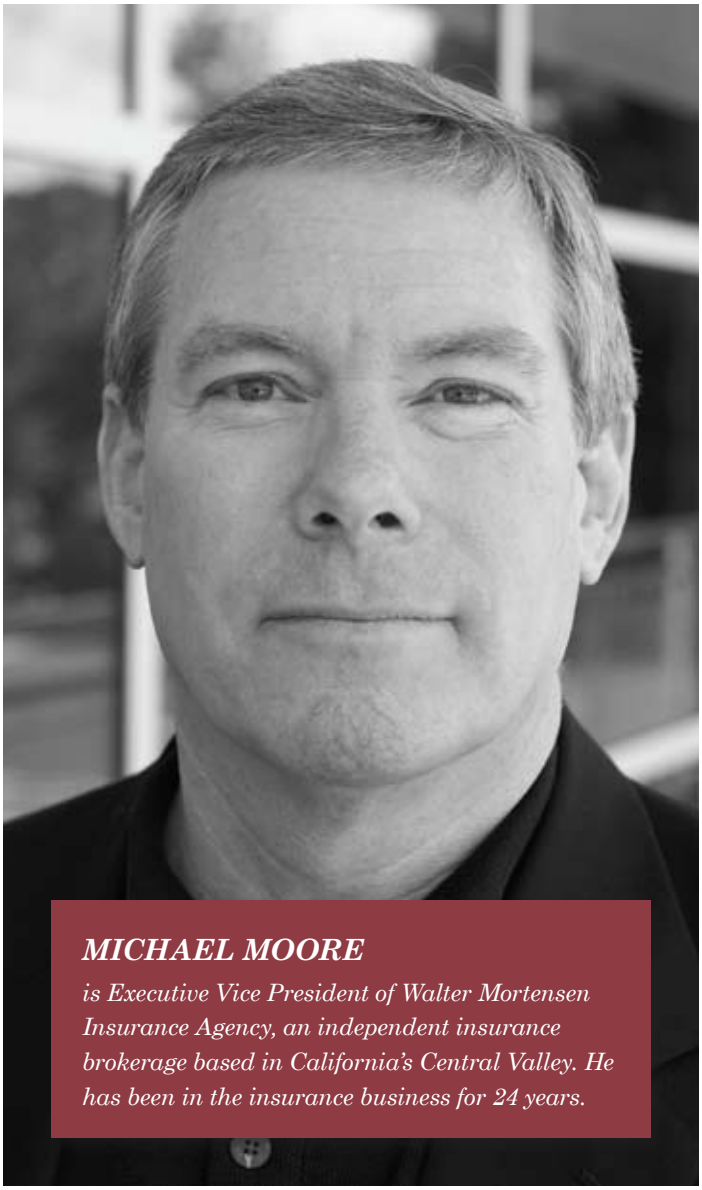
"In our business today, more and more companies are trying to underwrite via spreadsheets and computers, and either the square peg fits the square hole or not. One of the values of the broker-underwriter relationship is when you develop trust and can discuss what a particular account does vs. what every other similar account does. This enables the underwriter to better understand the account and give it appropriate pricing, rather than just an off-the-shelf model.

"That's one of the things we value most about working with State Fund. We have excellent relationships with their underwriters, there's good personal trust, and we can discuss issues openly with a healthy give-and-take—which invariably leads to a better resolution for our clients.

"We began working with Carrie Burt a few years ago and have an excellent day-to-day working relationship with her. She does a way better job than most underwriters we deal with from other companies. She's professional, returns calls in a timely manner, and understands the business. When Carrie calls and asks you about an account, she typically has already done the necessary research and is asking appropriate questions.

"State Fund has a broad appetite. Virtually any risk we come across, they can work with us to write with appropriate pricing. Their people have taken the time to learn the ins and outs of the particular businesses heavily represented in our area, so they have the resources that other carriers may not. They also do a great job on the education front for our clients.

"Over the years, I've seen carriers come and go in the California market. When times are good, they flock in; when things get bad, State Fund is one of the few that remains. If you have a dream to build a better business, make a better life for your family and a better situation for your community, if it weren't for State Fund, you wouldn't have that opportunity."



MICHAEL MOORE

is Executive Vice President of Walter Mortensen Insurance Agency, an independent insurance brokerage based in California's Central Valley. He has been in the insurance business for 24 years.

The Benefits of Policy Review Visits

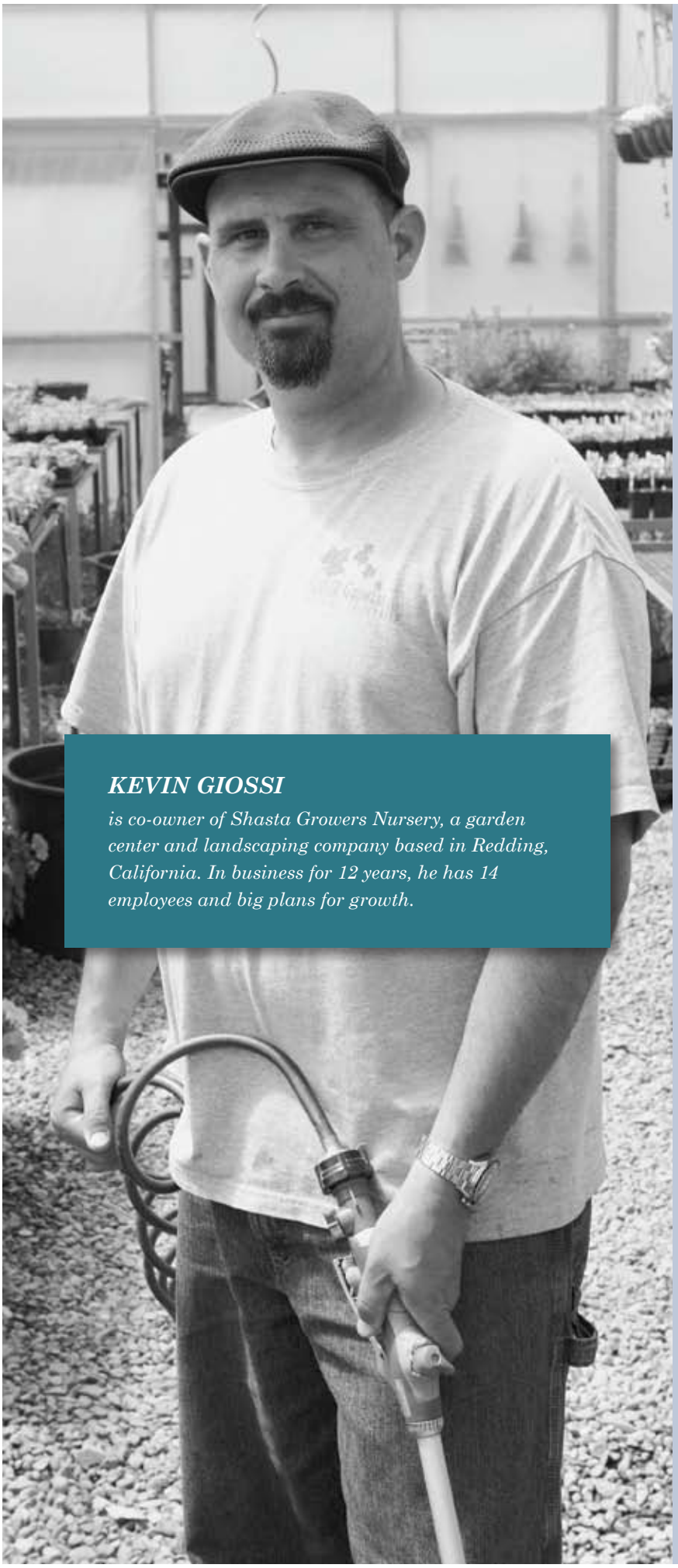
SHIRLENE SPAULDING

Senior audit specialist Shirlene Spaulding is an 18-year State Fund veteran. She spends most of her time in the field, conducting policy review visits with new and returning clients.

"In the policy review visit, we meet with clients prior to the audit—usually within the first three months of their policy's inception. In many cases they've never had workers' compensation insurance before, so it's the time to explain how the process works, exactly what's going on, and what they're paying for. You hear the word 'audit,' and people are immediately on the defensive. The policy review visit helps alleviate the fear of the audit. It helps make an easier transition.

"When we write a policy, we don't always get the total picture. Sometimes a third party is supplying the information. The broker brings us the business; they've talked to the client and written it up the way they've understood it. But when we physically meet with the business owner during our policy review visit, we sometimes find that apples are not oranges and there's been a misunderstanding. We're able to correct that before the end of the policy year—so the client won't have any surprises in their audit bill for having been classified incorrectly for their business type.

"Kevin Giossi is a perfect example. During his policy review visit, I learned that in addition to his wholesale nursery business, he'd started a retail business for walk-in customers. I added that classification for him, allowing him to take advantage of some dollar savings for his employees who had no exposure to his wholesale operation. My visit also gave Kevin a person to contact, someone from State Fund who's there for him whenever he has a question or an issue. Kevin has big plans to expand his business, and he knows that when he's ready he can call me anytime to ensure he's covered correctly."



KEVIN GIOSSI

is co-owner of Shasta Growers Nursery, a garden center and landscaping company based in Redding, California. In business for 12 years, he has 14 employees and big plans for growth.

"We've tried other insurance providers, but we've found that State Fund services us the best and gives us good rates. Shirlene Spaulding is awesome. She clearly likes what she does, and does it well. It's especially nice to have someone local we can talk to, who comes to see us and takes care of us. I really appreciate her for that.

"When we first signed up with State Fund, Shirlene came to our office for a policy review visit and brought me all the information and literature I needed to get the paperwork going for my employees. She found a classification for our retail people, which really helped out and saved me money. She's been here many times since that first visit, bringing me different paperwork that I need and helpful brochures like the *New Employee's Guide to Workers' Compensation*. She also helped me get set up with State Fund Online for ePayroll and ePayment access, which is a big benefit because I can go straight to the Internet to get information and pay our premiums.

"Now when I think of State Fund, I've got a face to put with that name, and it's great to have that kind of relationship. And it's reassuring to know Shirlene is within a 15-minute ride if I need to see her—and nice to have a phone number, so if I have any questions or something comes up, I can just call and talk to her.

"I see tremendous growth for our business, and that would include better facilities here, including an indoor area for sales. And obviously that growth is going to require more employees. It's comforting to know that State Fund will be there to support us, every step of the way."

FINANCIAL HIGHLIGHTS

DECEMBER 31, 2009 & 2008 (IN THOUSANDS)

		2009	2008	Percent Change
Assets	$	20,672,968	21,100,382	-2.03%
Premiums Earned		1,247,737	1,663,669	-25.00%
Net Investment Income		912,075	896,227	1.77%
Losses		939,825	1,251,950	-24.93%
Loss Adjustment Expenses		574,330	609,735	-5.81%
Net Income		143,001	75,063	90.51%
Policyholders' Surplus:		5,248,889	5,088,921	3.14%
Special Surplus for Retroactive Reinsurance		576,256	576,256	0.00%
Unassigned Surplus		4,672,633	4,512,665	3.54%
Premiums Earned to Policyholders' Surplus Ratio		**0.237714495**	**0.326919793**	

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

DECEMBER 31, 2009 & 2008

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, 2009 and 2008, 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, the practices of which 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, 2009 and 2008, 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, 2009 and 2008, 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 28, 2010

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

DECEMBER 31, 2009 & 2008 (IN THOUSANDS)

Admitted Assets		2009	2008
Bonds, at amortized cost	$	19,274,652	18,523,828
Real estate		384,878	378,387
Cash, cash equivalents, and short-term investments		466,914	1,540,210
Receivables for securities		3,109	1,850
Total cash and investments		**20,129,553**	**20,444,275**
Premiums in the course of collection		33,870	43,586
Deferred, earned but unbilled, and accrued retrospective premiums		37,706	49,277
Reinsurance recoverables		2,902	1,968
Accrued interest and dividends		173,443	189,929
Guaranty fund receivables		144,101	171,996
Due from adjusting contracts		44,917	65,799
Other assets		106,476	133,552
Total admitted assets	$	**20,672,968**	**21,100,382**

Liabilities and Policyholders' Surplus		2009	2008
Estimated liabilities for:			
Losses	$	13,839,355	14,488,903
Loss adjustment expenses		1,889,485	1,890,593
Retroactive reinsurance ceded		(762,197)	(835,871)
Unearned premiums		83,919	90,659
Guaranty fund assessments liability		8,433	9,931
Amounts held in trust liability		48,410	72,188
Other liabilities		316,674	295,058
Total liabilities		**15,424,079**	**16,011,461**
Special surplus for retroactive reinsurance		576,256	576,256
Unassigned surplus		4,672,633	4,512,665
Policyholders' surplus		**5,248,889**	**5,088,921**
Total liabilities and policyholders' surplus	$	**20,672,968**	**21,100,382**

See accompanying notes to statutory basis financial statements.

STATEMENTS OF OPERATIONS IN POLICYHOLDERS' SURPLUS (STATUTORY BASIS)

YEARS ENDED DECEMBER 31, 2009 & 2008 (IN THOUSANDS)

		2009	2008
Net premiums earned	$	1,247,737	1,663,669
Losses incurred		939,825	1,251,950
Loss adjustment expenses incurred		574,330	609,735
Underwriting and administrative expenses		456,433	537,747
Total underwriting deductions		**1,970,588**	**2,399,432**
Net underwriting loss		**(722,851)**	**(735,763)**
Investment income		956,035	1,030,707
Net realized capital gains (losses)		4,322	(86,668)
Investment expenses		(48,282)	(47,812)
Net investment income		**912,075**	**896,227**
Loss on premiums charged off (net of recoveries)		(46,208)	(87,502)
Net income before dividends to policyholders		**143,016**	**72,962**
Dividends to policyholders		15	(2,101)
Net income		**143,001**	**75,063**
Policyholders' surplus, beginning of year		5,088,921	4,908,725
Change in nonadmitted assets		16,232	86,746
Change in net unrealized capital gains		4,276	—
Change in provision for reinsurance		(3,541)	18,387
Policyholders' surplus, end of year	$	**5,248,889**	**5,088,921**

See accompanying notes to statutory basis financial statements.

STATEMENTS OF CASH FLOWS (STATUTORY BASIS)

YEARS ENDED DECEMBER 31, 2009 & 2008 (IN THOUSANDS)

		2009	2008
Premiums collected net of reinsurance	$	1,203,544	1,625,415
Net investment income		962,500	1,046,273
Recoveries from premiums charged off		16,463	29,843
Benefits and loss related payments		(1,590,308)	(1,819,726)
Other underwriting expenses		(968,873)	(1,020,355)
Net cash provided by operations		**(376,674)**	**(138,550)**
Proceeds from investments sold, matured, or repaid:			
Bonds		4,357,982	4,946,216
Real estate		—	14,691
Short-term investments and other		—	(12,166)
Cost of investments acquired:			
Bonds		(5,130,725)	(3,935,602)
Real estate		(15,369)	(50,355)
Net cash provided by (used in) investments		**(788,112)**	**962,784**
Other cash used		91,490	(254,181)
Net cash used in financing and miscellaneous sources		91,490	(254,181)
Net change in cash, cash equivalents, and short-term investments		(1,073,296)	570,053
Cash, cash equivalents, and short-term investments, beginning of year		1,540,210	970,157
Cash, cash equivalents, and short-term investments, end of year	$	**466,914**	**1,540,210**

See accompanying notes to statutory basis financial statements.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS)

DECEMBER 31, 2009 & 2008 (DOLLAR AMOUNTS IN THOUSANDS)

(1) History and Business

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

(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 90 days, plus all related amounts due that have been recorded on those policies; non-operating 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 90 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, loss adjustment expenses [see note 2 (f)], estimates related to premium deficiency calculations [see note 2 (g)], and State Fund's portion of the other post-employment benefit (OPEB) cost estimated by the State Controller's office based on the current actuarial valuation prepared for the State of California [see note 2 (j)].

(c) Cash, Cash Equivalents, and 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.

(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. State Fund's asset manager uses a proprietary model for loss assumptions and widely accepted models for prepayment assumptions in valuing mortgage-backed securities with inputs from major third-party data providers. It combines the effects of interest rates, volatility, and prepayment speeds based on various scenario (Monte Carlo) simulations with credit loss analysis and resulting effective analytics (spreads, duration, convexity) and cash flows on a monthly basis. Model assumptions are specific to asset class and collateral types and are regularly evaluated and adjusted where appropriate.

Statement values of bonds and preferred stock have been determined in accordance with the guidelines of the NAIC. Fair value is primarily determined by a widely accepted third-party vendor, followed by a hierarchy using broker/dealer quotes, Bloomberg, Yield Book analytic model, and a benchmark to index model. Fair-value estimates are made at a specific point in time and are based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Changes in assumptions could significantly affect these estimates. Since the fair value is estimated as of December 31, 2009, the amounts that will actually be realized or paid at settlement or maturity of the instruments could be significantly different.

Declines in the value of investments that are determined to be other than temporary, result in a reduction in carrying amount to fair value, or, for MBS's, to the present value of expected cash flows if management has the ability and intent to hold the MBS to recovery of that amount. 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 many factors including credit quality, market analysis, current events, and management's intent to hold or dispose of the asset. State Fund's Chief Investment Officer, Investment Team, and portfolio managers actively manage State Fund's investment risk by meeting weekly to discuss credit and default risk. Any strategy to hold or sell a security is discussed in these meetings and followed by discussions between the Chief Investment Officer and the Chief Financial Officer and/or the Chief Executive Officer as appropriate.

Investment expenses consist primarily of expenses incurred in the investing of funds and pursuit of investment income. Such expenses include custodial expenses, 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. 10% 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, 2009 and 2008. 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 2.6% and 1.2% of direct written premium for 2009 and 2008, 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.

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. Longshore 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 included in the "other liabilities" account as of December 31, 2009 and 2008, 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." Effective July 1, 2009, benefit reimbursements as well as interest charges for receivables that are past the grace period are paid to State Fund through the "Direct Transfer" program, which is the State Controller's Office terminology for an electronic fund transfer. Deposits and Service Fees are already paid through Direct Transfer since 2003 for Deposits and 2004 for Service.

(j) Retirement and Other Postemployment 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 post-employment 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 estimated employers' share of its current employees' retirement cost. State Fund paid pension expense of $68,355 and $68,360 for the years ended December 31, 2009 and 2008, respectively.

The State's OPEB plan provides medical, prescription drug, and dental benefits (health care benefits) to retired statewide employees. The authority for establishing and amending the OPEB plan lies with CalPERS, while the authority for establishing and amending the funding policy lies 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.

State Fund paid retiree health benefit pro rata assessments of $32,668 and $42,118 for the years ended December 31, 2009 and 2008, respectively. Additionally, 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 net OPEB obligation balance of $158,359 was accrued as a liability as of December 31, 2008. In January 2009, the State provided State Fund's 2009 funding requirements and its related 2009 contribution credit. For the year ended December 31, 2009, the ARC was $105,019. Of this amount, $35,756 was estimated as contributed for 2009. Accordingly, after deducting the estimated contribution of $35,756 and adding the State's ARC adjustment of $345, the remaining increase in net OPEB obligation of $69,608 was accrued as an additional liability for December 31, 2009.

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 employee health benefit costs for State Fund as compared to the total State active employee health benefit costs. The following table shows the components of State Fund's allocation of the State's 2009 and 2008 OPEB cost, the amount credited to the plan, and changes in the net OPEB obligation as of December 31, 2009 and 2008:

		2009	2008
Annual required contribution	$	105,019	239,638
Adjustment to annual required contribution		345	—
Annual OPEB cost		**105,364**	**239,638**
Estimated contribution credit		(35,756)	(81,279)
Increase in net OPEB		**69,608**	**158,359**
Net OPEB obligation beginning of year		158,359	—
Net OPEB obligation end of year	$	**227,967**	**158,359**

The percentage of annual OPEB costs contributed to the plan was 34% for 2009 and 2008.

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

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 is 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.

Based on information provided to State Fund by the State of California, in the June 30, 2009, 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 health care cost trend rate of 9% initially, decreasing each year over the next seven 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 2009.

(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 2008 to conform to the 2009 presentation.

(m) Recently Adopted Accounting Standards

In September 2008, the NAIC issued Statement on Statutory Accounting Principles (SSAP) No. 99, *Accounting for Certain Securities Subsequent to an Other Than Temporary Impairment*, with an effective date of January 1, 2009. This statement establishes the statutory accounting principles for the treatment of premium or discount applicable to certain securities subsequent to the recognition of an other-than-temporary impairment. After recognizing OTTI, the fair value on the impairment date becomes the new cost basis, and the insurer must amortize any premium or accrete any discount to the par value by the maturity date or to realizable value if the anticipated recovery is less than par. Discount is accreted over the remaining life of the security based on the amount and timing of future estimated cash flows. The adoption of SSAP 99 did not have a material impact on the statutory financial statements.

In September 2009, the NAIC issued SSAP No. 43 – Revised, Loan-backed and Structured Securities (SSAP 43R), which provides new guidance pertaining to loan-backed and structured securities and supersedes existing guidance regarding treatment of cash flows when quantifying changes in valuation and impairments of loan-backed and structured securities. The revised guidance requires impairment losses to be divided into interest and non-interest related portions. The non interest portion is the difference between the present value of cash flows expected to be collected from the security and its fair value at the balance sheet date. If the company has the intent and the ability to retain the investment to recovery, then only the non-interest loss is recognized through earnings. However, if the company does not have the intent and ability to hold the investment for a period of time sufficient to recover the present value of expected cash flows, the security must be written down to fair value and the loss recognized through earnings. This guidance requires a cumulative effect adjustment to statutory surplus as of July 1, 2009. SSAP 43R further requires additional disclosures, including a listing of all investments where the present value of cash flows is less than amortized cost for securities with a recognized other-than temporary impairment. SSAP 43R applies to investments held as of September 30, 2009, and to new investments purchased and held by the reporting entity after September 30, 2009. SSAR 43R does not have an impact to the Company's financial condition or results of operations. The Company does not purchase non-agency mortgage-backed securities, nor do its Investment Guidelines allow such investments.

In December 2009, the NAIC issued SSAP 100, Fair Value Measurements (SSAP 10), which is effective December 31, 2010. SSAP 100 defines fair value, establishes a measurement framework, and expands related disclosures. The Company anticipates that this statement will not have a material impact to its financial condition or results of operations.

(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, 2009, 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, 2009 and 2008 are as follows:

		2009			
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury securities and U.S. government-sponsored enterprise securities	$	4,345,130	143,512	(4,589)	4,484,053
Obligations of states and political subdivisions		518,244	4,056	(15,904)	506,396
Corporate debt securities		4,235,403	207,253	(5,006)	4,437,650
Special revenue		1,514,808	14,551	(44,416)	1,484,943
Other governments		234,902	6,745	(88)	241,559
Mortgage-backed securities		8,426,165	305,543	(14,314)	8,717,394
Totals	$	**19,274,652**	**681,660**	**(84,317)**	**19,871,995**

		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
Corporate debt securities		5,678,800	62,478	(172,891)	5,568,387
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**

State Fund's mortgage-backed holdings as of December 31, 2009 and 2008 consist solely of securities issued by FNMA, GNMA, and FHLMC, as follows:

		2009			
		Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
FNMA	$	3,107,033	114,074	(4,982)	3,216,125
GNMA		1,862,383	73,037	(4,855)	1,930,565
FHLMC		3,456,749	118,432	(4,477)	3,570,704
Totals	$	**8,426,165**	**305,543**	**(14,314)**	**8,717,394**
		2008			
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**

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, 2009 and 2008, 219 and 343 securities were in an unrealized loss position, which resulted in an unrealized loss of $84,317 and $232,850, respectively. State Fund management believes the unrealized loss position at the end of 2009 and 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. To determine whether to hold or sell an investment, State Fund's Chief Investment Officer, Investment Team, and portfolio managers actively manage State Fund's investment risk by meeting weekly to discuss credit and default risk in addition to short- and long-term investment strategies. Additionally, State Fund's investment department independently monitors rating changes on its entire portfolio daily followed by weekly discussions as appropriate. As of December 31, 2009, 99.76% of all bonds held by State Fund were rated Class 1 by the NAIC. State Fund concluded that the gross unrealized losses of $84,317 as of December 31, 2009, were temporary in nature.

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2009 and 2008.

		2009					
		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	$	472,553	(4,589)	—	—	472,553	(4,589)
Obligations of states and political subdivisions		348,208	(10,940)	39,307	(4,964)	387,515	(15,904)
Corporate debt securities		179,636	(3,588)	70,708	(1,418)	250,344	(5,006)
Special revenue		565,795	(14,803)	264,800	(29,613)	830,595	(44,416)
Other governments		7,310	(88)	—	—	7,310	(88)
Mortgage-backed securities		1,059,153	(13,224)	103.536	(1,091)	1,162,689	(14,315)
Totals	$	**2,632,655**	**(47,232)**	**478,351**	**(37,086)**	**3,111,006**	**(84,318)**

		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)
Corporate debt securities		2,408,490	(88,624)	806,280	(84,268)	3,214,770	(172,892)
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)**

The amortized cost and estimated fair value of bonds as of December 31, 2009, 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.

		2009	
		Amortized value	Estimated fair value
Due in one year or less	$	915,629	931,968
Due after one year through five years		5,285,703	5,519,800
Due after five years through ten years		3,357,209	3,460,690
Due after ten years		1,289,946	1,242,142
Mortgage-backed securities		8,426,165	8,717,394
Totals	$	**19,274,652**	**19,871,394**

Proceeds from sales and redemptions of investments in bonds during 2009 were $4,357,982, with gross realized gains of $59,874 and gross realized losses of $46,768. 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.

State Fund recognized a total of $8,783 and $101,594 other-than-temporary impairment in bonds for the years ended December 31, 2009 and 2008, respectively. The 2008 impairment in bonds was 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 $68,096 and $68,753 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, 2009 and 2008, respectively.

There were no loaned securities as of December 31, 2008. 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. For the year ended December 31, 2008, State Fund recognized other-than-temporary impairments which were included in net realized capital losses of $12,926. 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, nor does it invest directly in subprime fixed-income securities. As of December 31, 2009, State Fund has no direct subprime-mortgage-related risk exposure. However, State Fund does invest in AAA-rated mortgaged-backed securities that are backed by government agencies or government-sponsored entities, specifically Ginnie Mae, Fannie Mae, and Freddie Mac. These types of securities are collateralized by loans but are ultimately backed by the issuing agency. Ginnie Mae securities are guaranteed by the U.S. Treasury, and on December 25, 2009, Fannie Mae and Freddie Mac were granted unlimited financial assistance by the U.S. Treasury through 2012.

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, 2009, were $192 million and represent 0.29% of the total $67.2 billion balance in the State of California's Pooled Money Investment Account. Investments in the PMIA at December 31, 2009, included the following: 18.38% in Loans; 18.94% in Agencies; 37.43% in U.S. Treasuries; 6.51% in Collateralized Time Deposits; 9.62% in Certificates of Deposit and Bank Notes; 7.51% in Commercial Paper; 1.33% in Mortgages; and less than 0.28% in Corporate Bonds.

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 receivables and payables approximates fair value due to the short maturities of these investments. The Company has no assets or liabilities measured at fair value on a recurring basis as of December 31, 2009 and 2008. At December 31, 2009 and 2008, the Company did not have any material nonrecurring of nonfinancial assets or liabilities.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Company uses various methods including market, income, and cost approaches. The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

The Company categorizes its financial instruments into a three-level hierarchy based on the priority of the inputs to the valuation technique. The fair-value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair-value measurement of the instrument in its entirety.

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – inputs, other than quoted prices, that are observable by a marketplace participant, either directly or indirectly; and

Level 3 – unobservable inputs that are significant to the fair-value measurement.

At December 31, 2009, management believes that substantially all of the Company's investments are categorized as level 2 in the fair-value hierarchy. The Company identified five securities included in Level 3 with an aggregate fair-market value of $94.5M as of December 31, 2009.

(6) Real Estate, Furniture, and Equipment

Real estate as of December 31, 2009 and 2008 is composed of the following:

		2009	2008
Property occupied by the company	$	472,899	457,531
Property held for sale		—	—
Construction in progress		—	—
		472,899	**457,531**
Accumulated depreciation		(88,021)	(79,144)
Totals	$	**384,878**	**378,387**

Furniture and equipment as of December 31, 2009 and 2008 is composed of the following:

		2009	2008
Data processing equipment and software	$	111,177	108,485
Office furniture and equipment		174,803	152,523
		285,980	**261,008**
Accumulated depreciation		(235,292)	(210,913)
		50,688	**50,095**
Less nonadmitted assets		(48,146)	(48,449)
Totals	$	**2,542**	**1,646**

Depreciation expense on real estate was $8,877 and $8,208 for the years ended December 31, 2009 and 2008, respectively. Depreciation expense on furniture and equipment was $24,379 and $35,593 for the years ended December 31, 2009 and 2008, 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, 2009 and 2008. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of a loss portfolio transfer.

		2009	2008
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of $247,767 and $243,723, respectively	$	16,379,497	16,930,218
Add incurred related to:			
Current year		1,232,994	1,510,513
Prior years		281,161	351,172
Total incurred		**1,514,155**	**1,861,685**
Less paid related to:			
Current year		141,243	181,982
Prior years		2,023,569	2,230,425
Total paid		**2,164,812**	**2,412,407**
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of $247,767 and $243,723, respectively	$	**15,728,840**	**16,379,496**

Incurred losses and loss adjustment expenses relating to insured events in prior years were approximately $281,161 and $351,172 in 2009 and 2008, respectively. Increases to prior year incurred are attributable primarily to the strengthening of loss adjustment expense reserves.

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

State Fund had a significant increase in business volume during the 2002-2003 calendar years. Following that period of growth, a significant number of accounts returned to the private insurance market during the 2004-2009 period. 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, State Fund has no significant asbestos and environmental exposure aggregations. Asbestos and environmental claims are handled in the routine course of business. Claims are made up on a per-claimant basis. At December 31, 2009, State Fund identified 1,349 open asbestos cases with aggregate outstanding case reserves of $25,000, or an average outstanding case reserve of approximately $18.5 per claim. At December 31, 2008, State Fund identified 1,580 open asbestos cases with aggregate outstanding case reserve of $26,500, or an average outstanding case reserve of approximately $17 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, 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.

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 $505,432 and $471,571 as of December 31, 2009 and 2008, 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, 2009 and 2008:

		2009	2008
Genworth Financial	$	103,978	100,460
Hartford Life Insurance		109,109	100,859
Aviva Life Insurance Company		101,662	100,163
Totals	$	**314,749**	**301,482**

(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 presentation purposes as though State Fund is not liable for reinsured losses. State Fund, however, has a contingent risk with respect to insurance ceded to the extent that reinsurers would be unable to meet the obligations assumed under reinsurance contracts.

As respects natural catastrophes, State Fund was covered in 2009 by per occurrence excess of loss reinsurance treaties for $900,000 of losses excess of $300,000 for a catastrophe involving 20 or more claimants. The treaties 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 2009 by a combination of private reinsurance and the federal Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA). Coverage included losses generated from nuclear, biological, chemical, or radiological events. Private reinsurance provided $300,000 of coverage excess of a $300,000 retention on an aggregate annual basis. Above $340,000, TRIPRA provided coverage for 85% of losses related to certified acts of international terrorism having a minimum industry aggregate impact in excess of $300,000. Private reinsurance provided coverage in the 15% TRIPRA coinsurance corridor up to a limit of $260,000.

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 Risk Insurance 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.

For the years ended December 31, 2009 and 2008, total earned premiums ceded under the reinsurance contracts were $34,800 and $58,742, respectively.

Based upon the estimated reinsurance recoverable under reinsurance treaties for years 1968 through 1982, 1985, and 1988 through 2004, State Fund's liabilities for losses were reduced by $ 239,020 and $247,767 as of December 31, 2009 and 2008, respectively, including $71,239 and $56,683 recoverable from Munich Re America Reinsurance Co. and Reliastar Life Insurance Co., respectively, as of December 31, 2009, and $75,825 and $59,961 as of December 31, 2008, respectively.

As of December 31, 2009, State Fund commuted reinsurance recoverables of $337 from LDG Reinsurance Company. These are reflected as losses incurred and loss adjustment expenses incurred amounting to $336 and $1, respectively. The commutation agreement has a clause that requires State Fund to reimburse $116 to the reinsurer in the event that the claimant dies within six months from the date of the agreement.

As of December 31, 2009, State Fund wrote off reinsurance balances due (from the companies listed below) of $115. These are reflected as losses incurred and loss adjustment expenses incurred amounting to $114 and $1, respectively.

		2009
US International Reinsurance	$	91
Classic Fire & Marine Insurance		24
Total	$	**115**

There were no 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 the 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 2008 and 2009.

As of December 31, 2009 and 2008, cumulative subject paid losses were $1,589,341 and $1,471,254, respectively, which exceeded the $950,000 retention. These netted to a total receivable of $575,407 and $469,129 from the Reinsurers (after State Fund's 10% retention) as of December 31, 2009 and 2008, respectively, of which $542,803 and $441,844 were collected from the Reinsurers as of December 31, 2009 and 2008, respectively. There were no net receivables from the Reinsurers as of December 31, 2009, and $27,284 as of December 31, 2008.

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.

The LPT contains a provision under the "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. This provision was triggered in 2009. The Company and the Reinsurer are in the process of amending the LPT contract to ease settlement of such transactions.

(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, 2009, were as follows:

Year			
	2010	$	34,887
	2011		28,612
	2012		22,678
	2013		11,148
	2014		6,901
	Thereafter		1,056
	Total	$	**105,282**

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, 2009 and 2008, the total rental expense for office space was $63,824 and $63,863, respectively, which included an allocation of rental value to space owned and occupied by State Fund of $38,217 and $35,540, respectively. Vehicle and other lease expenses were $19,862 and $20,940 for the years ended December 31, 2009 and 2008, 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, asserting a claim for interest on policyholder deposits, was resolved in favor of State Fund but has been appealed. The second case was filed at the Workers' Compensation Appeals Board on behalf of injured workers seeking 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, sought damages for alleged outstanding balances for medical bills paid below the Official Medical Fee Schedule's rate of reimbursement, and was resolved in favor of State Fund. 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. 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.

State Fund is currently evaluating the reporting of taxable income related to employees' fringe benefits and believes that the amount of potential liability, if any, will not materially affect the results of operations or the financial position of State Fund.

On December 19, 2008, Governor Schwarzenegger issued an Executive Order furloughing the state workforce two days a month. State employees challenged the legality of the furloughs through several lawsuits in Sacramento Superior Court and San Francisco Superior Court. Two lawsuits were resolved in favor of State Fund employees. One of the two suits was upheld on appeal, and an appellate decision is pending in the other. State Fund issued court-ordered payments of back wages and interest to its employees. On May 20, 2010, the California Supreme Court granted review of its own motion of the appellate decision in the lawsuit brought by the California Attorneys, Administrative Law Judges, and Hearing Officers in State Employment against Governor Schwarzenegger. State Fund is evaluating what the operational or financial impact would be in the event of an adverse ruling on either case.

(10) 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. 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 composed 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.

The CDI is currently conducting its triennial financial audit of the Company for the years ended December 31, 2007, 2008, and 2009.

NOTES TO FINANCIAL STATEMENTS (STATUTORY BASIS) *continued*

DECEMBER 31, 2009 & 2008 (DOLLAR AMOUNTS IN THOUSANDS)

(11) 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 were predicting 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 are 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 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 in the Permanent Disability Rating Schedule. Applicant 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.

On July 28, 2009, legislation was enacted authorizing the Director of Finance acting as agent for the State of California to sell a portion of or otherwise obtain value for the State Compensation Insurance Fund's workers' compensation insurance assets and liabilities with the intent of raising $1B in state revenue and to deposit the proceeds of sale or proceeds achieved through any other disposition, less transaction costs, into the State's General Fund. On August 28, 2009, Insurance Commissioner Poizner filed a lawsuit in Sacramento Superior Court to declare the legislation unconstitutional and enjoined the Director of Finance and the Treasurer from implementing this legislation. State Fund is named in the lawsuit as a real party in interest. State Fund management is currently evaluating the potential impact of this legislation and ensuing lawsuit.

As a result of recently enacted federal health care reform legislation, substantial changes are anticipated in the United States health care system that could impact the delivery of health care services, the financing of health care costs, and the legal obligations of insurers, providers, and employers. These provisions are currently slated to take effect at specified times over approximately the next decade. Since health care costs are the largest component of our loss costs, we may be impacted by this new health care legislation. The extent of this impact, if any, is not known at this time. This federal health care reform legislation does not affect the 2009 statutory financial statements.

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES

DECEMBER 31, 2009 (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, 2009 (DOLLAR AMOUNTS IN THOUSANDS)

State Fund had the following invested assets as of December 31, 2009:

		Gross investments holdings		Admitted assets as reported in the annual statement	
		Amount (in thousands)	Percentage	Amount (in thousands)	Percentage
Bonds:					
U.S. treasury securities	$	2,470,799	12.3%	2,470,799	12.3%
U.S. government agency obligations (excluding mortgage-backed securities):					
Issued by U.S. government agencies		—	—	—	—
Issued by U.S. government-sponsored agencies		1,874,331	9.3	1,874,331	9.3
Foreign government (including Canada)		234,902	1.2	234,902	1.2
Securities issued by states, territories and possessions, and political subdivisions in the U.S.:					
States, territories, and possessions general obligations		262,473	1.3	262,473	1.3
Political subdivisions of U.S. States, territories, and possessions general obligations		255,770	1.3	255,770	1.3
Revenue and assessment obligations		1,514,808	7.5	1,514,808	7.5
Mortgage-backed securities (includes residential and commercial MBS):					
Pass-through securities:					
Issued or guaranteed by GNMA		1,229,009	6.1	1,229,009	6.1
Issued or guaranteed by FNMA and FHLMC		5,169,799	25.7	5,169,799	25.7
CMOs and REMICs:					
Issued or guaranteed by FNMA, FHLMC, GNMA, or VA		2,027,358	10.1	2,027,358	10.1
All other		—	—	—	—
Other debt and other fixed-income securities (excluding short-term):					
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)		4,235,403	21.0	4,235,403	21.0
Unaffiliated foreign securities		—	—	—	—
Real estate investments:					
Property occupied by the company		384,878	1.9	384,878	1.9
Property held for sale		—	—	—	—
Receivable for securities		3,109	0	3,109	0
Cash, cash equivalents, and short-term investments		466,914	2.3	466,914	2.3
Total cash and investments	$	**20,129,553**	**100.0%**	**20,129,553**	**100.0%**

See accompanying independent auditor's report.

SUPPLEMENTAL INVESTMENT RISK INTERROGATORIES

DECEMBER 31, 2009 (DOLLAR AMOUNTS IN THOUSANDS)

State Fund's total admitted assets as filed in the 2009 Annual Statement are: **$20,672,968**

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	$	142,282	0.7%
Honeywell International	Industrial & Miscellaneous		130,575	0.6
John Deere Capital Corp.	Industrial & Miscellaneous		129,595	0.6
Boeing Co.	Industrial & Miscellaneous		123,295	0.6
General Electric Capital Corp.	Industrial & Miscellaneous		113,232	0.5
Praxair Inc.	Industrial & Miscellaneous		111,063	0.5
Southern California Public Power Authority PW	Special Revenue		111,052	0.5
General Dynamics Corp.	Industrial & Miscellaneous		110,468	0.5
Emerson Electric Co.	Industrial & Miscellaneous		101,876	0.5
Cisco Systems, Inc.	Industrial & Miscellaneous		100,435	0.5

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

Rating		Amount	Percentage of total admitted assets
NAIC – 1	$	19,526,054	94.5%
NAIC – 2		47,125	0.2
NAIC – 3		—	—
NAIC – 4		—	—
NAIC – 5		—	—
NAIC – 6		—	—

State Fund does not have any preferred stocks.

State Fund does not hold any foreign investments.

State Fund's Canadian investments are 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.

SUPPLEMENTAL PROPERTY & CASUALTY REINSURANCE INTERROGATORIES

DECEMBER 31, 2009 (DOLLAR AMOUNTS IN THOUSANDS)

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) Except for the exception detailed below, 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, 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);

(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

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

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

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

Regional Offices

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

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

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

Bay Area
5880 Owens Drive
Pleasanton, CA 94588
(925) 523-5200 Claims Services
(925) 523-5100 Policy Services

Orange County
1750 E. Fourth Street
Santa Ana, CA 92705
(714) 565-5000 Claims Services
(714) 565-5995 Policy Services

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

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

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

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

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

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

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

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

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

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

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

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

Group Insurance Offices

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

Pleasanton
5890 Owens Drive
Pleasanton, CA 94588
(800) 533-6868

State Contract Offices

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

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

Alternative Dispute Resolution
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

Fraud Reporting Hotline
Toll-Free Number:
(888) 786-7372

STATEFUNDCA.COM

STATE
COMPENSATION
INSURANCE
FUND

on the job

2009 ANNUAL REPORT

PRINTED ON RECYCLED PAPER
PRINTED IN THE U.S.A.