COMPLETED CLOSED AUDITS

PAO 593 Data Integrity Audit Summary

Internal Audit evaluated State Contract claims transactions that involved payments, journal voucher entries, ECF subrogation entries, manual cash receipts, and claims file transfers which occurred during the period of October 2009 through February 2010. The objective of the audit was to assess the process controls in place for each transaction type and determine if those controls help ensure data accuracy. The audit identified some processes that could be improved. These included: the reconciliation of manual entries between databases, improvement to procedures for key-data operators, and the identification of process flow and data migrations defects related to two applications, ECF and SAL.

The impacted business units have acknowledged these process control findings and have developed appropriate action plans to have them remediated. Anticipated remediation will be in place Qtr 3 and Internal Audit will confirm.

California Department of Insurance (CDI) Statutory Financial Examination of the State Compensation Insurance Fund as of December 31, 2009

The on site auditing began on February 1, 2010. CDI reviewed State Fund's business activity and financials from January 1, 2007 through December 31, 2009. The audit is complete and the report, filed June 15, 2011, is attached.

REPORT OF EXAMINATION
OF THE

STATE COMPENSATION INSURANCE FUND

AS OF
DECEMBER 31, 2009

Dave Jones
Insurance Commissioner
FILED 6-15-11

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San Francisco, California
May 26, 2011

Honorable Dave Jones
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

STATE COMPENSATION INSURANCE FUND

(hereinafter also referred to as the Fund) at its home office located at 1275 Market Street, San Francisco, California 94103.

SCOPE OF EXAMINATION

The previous limited-scope examination of the Fund was made as of December 31, 2006. This examination covers the period from January 1, 2007 through December 31, 2009. The examination was conducted in accordance with the National Association of Insurance Commissioners' Financial Condition Examiners' Handbook. The Handbook requires the planning and performance of the examination to evaluate the Fund's financial condition, to identify prospective risks, and to obtain information about the Fund, including corporate governance, identification and assessment of inherent risks, and the evaluation of the system controls and procedures used to mitigate those risks. The examination also included an assessment of the principles used and the significant estimates made by management, as well as an evaluation of the overall financial statement presentation, and management's compliance with Statutory Accounting Principles and Annual Statement instructions. All accounts and activities of the Fund were considered in accordance with the risk-focused examination process.

In addition to those items specifically commented upon in this report, other phases of the Fund's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; pensions and insurance plans; loss experience; and sales and advertising.

Also, RSM McGladrey, Inc. (RSM) performed a follow-up operational review pursuant to the California Insurance Commissioner's instructions. RSM issued a separate report in December 2010, covering the operational review.

SUBSEQUENT EVENTS

In December 2010, the Fund announced a three-year strategy to reduce its expenses, improve operating efficiency, and to reduce employment exposure in high-cost areas. The strategic plan outlines the Fund's goal to reduce its real estate footprint and consolidate many of its current operations. Beginning in September 2011, the Fund will significantly reduce the size of its Home Office presence in San Francisco and relocate many corporate functions to offices in Pleasanton, Vacaville, and Sacramento. Over the next three years, the Fund will also consolidate its regional claims and underwriting functions into central locations in Eureka, Redding, Sacramento, Stockton, Pleasanton, Fresno, Bakersfield, Monterey Park, Riverside, and Santa Ana. The strategy is designed to save the Fund $200 million in annual operating costs over the next three years.

FUND HISTORY

The Fund's organization and powers are defined by California Insurance Code Sections 11770 through 11805. The Fund was created by the California Legislature in 1914, concurrently with the enactment of the first compulsory workers' compensation laws in California, to assure California employers of the availability of workers' compensation insurance coverage at the lowest possible cost.

MANAGEMENT AND CONTROL

Pursuant to California Insurance Code Section 11770, the Board of Directors of the Fund is composed of 11 members, 9 of whom are appointed by the Governor, including the Chairperson and one of whom shall be from organized labor. One member is appointed by the Speaker of the Assembly (this member also represents organized labor). One member is appointed by the Senate Committee on Rules. The Director of Industrial Relations is an ex-officio, non-voting member of the board, and is not counted as a member of the board for quorum purposes or any other purpose. Following the initial terms of office, the subsequent terms of the members of the board, other than the Director of Industrial Relations, are five years, and they hold office until the appointment of their successors.

A listing of the directors and principal officers as of December 31, 2009, as well as subsequent changes, follows:

Directors

Name and Residence	Principal Business Affiliation
Jeanne Cain (1) Rocklin, California	Senior Vice President California Chamber of Commerce
Sheryl Chalupa Bakersfield, California	President and Chief Executive Officer Goodwill Industries of South Central California
John Duncan (2) Tiburon, California	Director Department of Industrial Relations
Francis Quinlan Corona del Mar, California	Special Counsel Archer Norris, PLC
Daniel Curtin, Sacramento, California	Director California Conference of Carpenters
Senator Michael Machado (Retired) Linden, California	Partner FDR Farms

Name and Residence	Principal Business Affiliation
Steven Rank Roseville, California	Director Western Region of the Ironworker Management Progressive Action Cooperative Trust
Thomas Rankin Berkeley, California	President Emeritus California Labor Federation AFL-CIO
Donald Garcia Tustin Ranch, California	President Pinnacle Consulting Group
Lawrence Mulryan (1) San Rafael, California	Executive Director Emeritus California Insurance Guarantee Association
James Richardson (3) Elk Grove, California	President and Chief Executive Officer California Dental Association/TDIC Insurance Solutions
William Zachry San Carlos, California	Vice President, Risk Management Safeway, Inc.

(1) Ms. Cain's term expired in January 2011. Lawrence Mulryan was appointed by Governor Schwarzenegger to replace Ms. Cain as Board Chairperson.

(2) Mr. Duncan resigned in April 2011. He was replaced by Christine Baker.

(3) Mr. Richardson resigned effective March 17, 2011.

Principal Officers

Name	Title
Douglas V. Stewart (1)	Interim President/Chief Executive Officer
Jay H. Stewart (2)	Chief Financial Officer
Carol Newman	General Counsel
Harrison D. Jerome (3)	Chief Operating Officer
Peter A. Guastamachio	Chief Investment Officer
Shaun Coyne	Chief Information Technology Officer
James F. Neary (4)	Executive Vice President
Linda Hoban (3)	President/Claims Operations
Tom Clark (5)	President/Field Operations

(1) In August 2010, Tom Rowe was appointed as the Fund's Chief Executive Officer and President. Douglas Stewart resumed his position as the Fund's Chief Risk Officer (CRO). Mr. Stewart resigned from the Fund in December 2010. In January 2011, Ken Van Laar was appointed as the Fund's CRO.

(2) In October 2010, Jay Stewart resigned from the Fund to accept a similar position with another insurance company. In January 2011, Dan Sevilla was appointed as the Fund's CFO.

(3) In December 2010, Linda Hoban, President of Claims Operations, and Harrison Jerome, Chief Operating Officer, retired from the Fund. Ms. Hoban's position as President of Claims Operations was restructured in October 2010, creating two executive vice president (EVP) positions: Field Claims and Corporate Claims. In December 2010, Julie Jenkinson was appointed as EVP of Corporate Claims and Beatriz Sanchez was appointed as EVP of Field Claims.

(4) In November 2010, James Neary retired from the Fund.

(5) In December 2010, Tom Clark was appointed as the Fund's Chief Operating Officer.

TERRITORY AND PLAN OF OPERATION

The Fund is authorized to write workers' compensation insurance, including liability under the United States Longshore & Harbor Workers' Compensation Act, in the State of California. It also insures the temporary workers' compensation exposures in other states for California employers insured by the Fund.

Brokers remain the primary source of business for the Fund. Premium produced by brokers accounted for 62%, 63%, and 66% of total annual premium for 2009, 2008, and 2007, respectively.

The Fund conducts operations from its home office in San Francisco. Through a network of six regional offices, Northern and Southern management teams administer three regional offices each and five state contract offices. The offices provide claims adjustment and policy services. Customer Service Centers located in Monterey Park and Vacaville provide servicing support for assigned policies. The Customer Service Centers also handle first reports of injury for assigned policies; referrals to medical facilities; and issue premium quotes for assigned renewals.

GROWTH OF FUND

The Fund's market share declined by approximately 4% each year from 2007 to 2009. Market share was 26.5% for 2007, 22.6% for 2008, and 18.6% for 2009. The following schedule reflects the net earned premiums and policyholder surplus as reported by the Fund from 2000 to 2009, along with the Fund's unadjusted market share:

	Net Earned Premiums	Surplus as Regards Policyholders	Unadjusted Market Share
2000	$1,728,461,860	$1,350,333,158	20%
2001	$3,595,208,483	$1,431,381,866	43%
2002	$5,359,292,398	$1,449,361,255	50%
2003	$7,633,199,935	$2,085,877,169	53%
2004	$7,198,319,378	$2,862,495,032	51%
2005	$5,946,400,817	$3,785,052,242	42%
2006	$3,477,664,650	$4,496,655,498	32%
2007	$1,753,485,169	$4,908,725,359	27%
2008	$1,663,669,200	$5,088,920,987	23%
2009	$1,247,737,029	$5,248,888,706	19%

This decrease in market share created challenges for the Fund in managing its overall expense and overhead structure going forward. Market conditions from 2007 to 2009 (economic downturn, lower statewide payroll, and a competitive soft market) affected the Fund's premium volume. The result was reduced premium and increased loss adjustment expenses ratio and other underwriting expenses ratio. In addition, the Fund's substantial market share from 2001 to 2004 produced a large inventory of open claims that influenced the 2007 to 2009 loss development. The incurred loss ratio increased 5% from 70.4% in 2007 to 75.3% in 2009. Loss adjustment expenses ratio increased by nearly 20 percentage points over three years, from 27.2% in 2007 to 46% in 2009.

REINSURANCE

Assumed

The Fund had no assumed premium written during the period covered by this examination and has no liability for assumed losses or loss adjustment expenses as of December 31, 2009.

Ceded

Natural Catastrophe Excess of Loss: In 2009, the Fund maintained natural catastrophe reinsurance that covered $900 million in excess of the Fund's basic retention of $300 million, per occurrence, for catastrophic events not caused by an act of international terrorism. The catastrophe treaties consisted of two layers and covered all business classified as Workers' Compensation and Employers' Liability, including the United States Longshore and Harbor Workers' Compensation Act (USL&H). The Fund's maximum ultimate net loss under these treaties was $15 million for any one life in any one occurrence.

Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA): In addition to natural catastrophe reinsurance, the Fund was covered in 2009 for terrorist events, including nuclear, biological, chemical, and radiological events, by a combination of private reinsurance and Federal TRIPRA. The Fund retains the first $300 million of aggregate annual losses caused by terrorism. Private reinsurance then provides $40 million of aggregate annual excess coverage to the level of TRIPRA retention, which is 20% of the previous year's direct earned premium, and 15% coinsurance with TRIPRA (which covers 85%) up to $2 billion. TRIPRA coverage extends to an aggregate industry limit of $100 billion. The Fund's maximum ultimate net loss under the private treaty is $15 million for any one life in any one act of terrorism.

Loss Portfolio Transfer: The Fund entered into a loss portfolio transfer agreement in August, 2002. The contract covers workers' compensation losses only. Loss adjustment expenses, employers' liability and USL&H losses are excluded in the agreement. Under this agreement, the Fund ceded certain loss reserves relating to the accident years 1980 to 1998 to XL Capital Ltd. and ACE Ltd. In a later novation agreement, all of ACE's liability was transferred to XL Capital who remains as the only reinsurer. Under the terms of the contract, the Fund retained the first $950,000,000 of losses. The reinsurance coverage is for 90% of losses in the covered layers. Initially, the reinsurers cover $1,035,000,000 of the next layer of $1,150,000,000 of losses. The Fund retains a further layer of $200,000,000 excess $2,100,000,000 with the reinsurers covering $270,000,000 of a layer of $300,000,000 excess $2,300,000,000. The Fund has the sole right to terminate the contract on or after December 31, 2008 for payment at a specified formula, but thus far has chosen not to do so. Ceded premium under the contract was

$713,452,806 ($726,952,806 less $13,500,000 on deposit with the reinsurers).

As a result of this transaction, and in accordance with Statements of Statutory Principles (SSAP) 62, the Fund recorded a contra liability against loss reserves of $1,035,000,000 and a retroactive reinsurance gain of $319,756,350 included under other income. 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 the Fund for the loss portfolio transfer.

Commutation of Ceded Reinsurance: During 2009, the Fund exercised one commutation with LDG Reinsurance Company which released the reinsurer from future liability, of which $337,587 in losses and LAE was known at the time, in exchange for an immediate payment of $231,914. The known liability represented a single claimant and the agreement included a clause requiring the Fund to reimburse 50% of the commutation proceeds if the claimant passed away within 6 months of the commutation date. This did not occur and the entire proceeds were retained by the Fund.

ACCOUNTS AND RECORDS

Information Systems Controls

During the course of the examination, a review was conducted of the Fund's general controls over its information systems. As a result of this review, weaknesses were noted in areas such as logical security and operations. The weaknesses noted were presented to the Fund, along with recommendations to strengthen its controls. The Fund should evaluate the recommendations and make appropriate changes to strengthen its information system controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2009

Underwriting and Investment Exhibit for the Year Ended December 31, 2009

Reconciliation of Surplus as Regards Policyholders
from December 31, 2006 through December 31, 2009

Statement of Financial Condition as of December 31, 2009

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$19,274,652,106	$	$19,274,652,106	
Real estate	384,877,658		384,877,658	
Cash and short-term investments	466,913,598		466,913,598	
Receivable for securities	3,109,421		3,109,421	
Investment income due and accrued	173,443,474		173,443,474	
Uncollected premiums and agents' balances in the course of collection	165,296,331	131,426,223	33,870,108	
Deferred premiums, agents' balances and installments booked but deferred and not yet due (including $37,705,761 earned but unbilled premiums)	41,895,303	4,189,542	37,705,761	
Amounts recoverable from reinsurers	2,902,146		2,902,146	
Guaranty funds receivable or on deposit	146,446,663	2,345,461	144,101,202	
Electronic data processing equipment and software	41,527,308	38,984,499	2,542,809	
Furniture and equipment	9,161,022	9,161,022		
Aggregate write-ins for other than invested assets	148,855,814	5,722	148,850,092	
Total assets	$20,859,080,844	$ 186,112,469	$20,672,968,375	

Liabilities, Surplus and Other Funds

Losses		$13,839,355,286	(1)
Loss adjustment expenses		1,889,485,234	(1)
Commissions payable, contingent commissions and other similar charges		30,047,749	
Other expenses		117,694,878	
Taxes, licenses and fees		13,764,832	
Unearned premiums		83,918,722	
Advance premium		581,195	
Dividends declared and unpaid: policyholders		1,000,000	
Ceded reinsurance premiums payable		(8,700,000)	
Amounts withheld or retained by company for account of others		48,409,642	
Remittances and items not allocated		2,579,119	
Provision for reinsurance		3,713,620	
Aggregate write-ins for liabilities		(597,771,608)	
Total liabilities		15,424,078,669	
Aggregate write-ins for special surplus funds	$ 576,256,350		
Unassigned funds (surplus)	4,672,633,356		
Surplus as regards policyholders		5,248,889,706	
Total liabilities, surplus and other funds		$20,672,968,375	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2009

Statement of Income

Underwriting Income		
Premiums earned		$1,247,737,030
Deductions:		
Losses incurred	$939,825,557	
Loss adjustment expenses incurred	574,329,683	
Other underwriting expenses incurred	456,432,643	
Total underwriting deductions		1,970,587,883
Net underwriting loss		(722,850,853)
Investment Income		
Net investment income earned	$907,752,397	
Net realized capital gains	4,322,420	
Net investment gain		912,074,817
Other Income		
Net loss from agents' or premium balances charged off	$ (46,207,828)	
Total other loss		(46,207,828)
Net income before dividends to policyholders		143,016,136
Dividends to policyholders		14,702
Net income		$ 143,001,434

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2008		$5,088,920,987
Net income	143,001,434	
Change in net unrealized capital gains	4,276,280	
Change in nonadmitted assets	16,232,499	
Change in provision for reinsurance	(3,541,494)	
Change in surplus as regards policyholders for the year		159,968,719
Surplus as regards policyholders, December 31, 2009		$5,248,889,706

Reconciliation of Surplus as Regards Policyholders from December 31, 2006 through December 31, 2009

Surplus as regards policyholders, December 31, 2006 per Examination		$ 4,496,655,498
	Gain in Surplus	
Net income	$544,966,451	
Net unrealized capital gains	4,048,260	
Change in nonadmitted assets	187,647,431	
Change in provision for reinsurance	15,572,063	
Aggregate write-ins for gains and losses in surplus	3	
Total gains	$752,234,208	
Net increase in surplus as regards policyholders		752,234,208
Surplus as regards policyholders, December 31, 2009, per Examination		$ 5,248,889,706

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The California Department of Insurance (CDI) retained an independent Consulting Actuary to evaluate the loss and loss adjustment expense reserves (loss reserves) as of December 31, 2009. In addition, a CDI Senior Casualty Actuary reviewed the work of the Consulting Actuary, and performed additional analysis as deemed appropriate. The Consulting Actuary's reviews indicated a shift in recent accident years to more 'permanent' rather than 'temporary' types of injury claims. It was also noted that the closure rate in 2010 of the medical component of permanent claims is trending significantly lower than the prior years and the incurred loss development factors for 2010 are substantially higher. Finally, the Consulting Actuary noted a deficiency relating to loss adjustment expense reserves as well as a redundancy in loss reserves.

In order to reduce expenses, the Fund has embarked upon a strategic expense reduction plan. If successful, this initiative could significantly reduce the indicated loss adjustment expense reserve deficiency. For a further discussion of the Fund's expense reduction plan, see the Subsequent Events section of this report.

Based on the analyses performed by the CDI's Consulting Actuary and CDI Senior Casualty Actuary, the CDI has determined that the loss and loss adjustment expense reserves as reported by the Fund are reasonable though the aforementioned trends will be monitored.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

There were no comments and recommendations.

Previous Report of Examination

Management and Control – Corporate Governance (Page 7): It was recommended that the Fund hire a permanent Chief Financial Officer to implement and monitor effective internal controls, and to improve existing functions of accounting, budgeting and financial reporting. The Fund has complied with this recommendation.

It was recommended the Fund hire a Chief Operating Officer to oversee the executives who direct the activities of various departments within the Fund. The Fund has complied with this recommendation.

It was recommended that the Fund hire a Chief Information Officer charged with, at minimum, the duties outlined within this report. The Fund has complied with this recommendation.

It was recommended that the Fund hire a Chief Investment Officer who would be responsible for the management and oversight of the Fund's investment portfolio. The Fund has complied with this recommendation.

It was recommended that the Board take action to ensure that its members do not personally benefit, either directly or indirectly, as a result of decisions made by the Board. The Fund has complied with this recommendation.

It was recommended that the Fund take the steps necessary to address control deficiencies noted in its financial reporting function. The Fund has complied with this recommendation.

Accounts and Records – Accrual of Expenses (Page 14): It was recommended that the Fund implement controls to ensure that unrecorded liabilities are identified and calculated for inclusion in the proper accounting period. The Fund has complied with this recommendation.

Accounts and Records – Classification of Expenses in the Underwriting and Investment Exhibit (Page 15): It was recommended that the Fund separately identify and report the group administration fees and information technology consulting expenses as miscellaneous write-ins in the Underwriting and Investment Exhibit. It was also recommended that the Fund implement controls to prevent future misclassification of these expenses. The Fund has complied with these recommendations.

Accounts and Records –Controls over Encumbrances (Page 17): It was recommended that the Fund review all budgeting policies and procedures and implement strict controls over budgeting practices. The Fund has complied with this recommendation.

Accounts and Records - Information Systems Controls (Page 17): It was recommended that the Fund evaluate the recommendations from the information systems controls review and make appropriate changes to strengthen its controls over its information systems. The Fund has implemented changes to strengthen its controls over information systems. Additional recommendations were made during the current examination.

Comments on Financial Statement Items – Bonds, Stocks and Short-term Investments (Page 21): It was recommended that the Fund limit its investments to those permitted under California Insurance Code (CIC) Section 11797. Regarding this recommendation, California Senate Bill 1407 was signed into law on September 30, 2010. This bill expands the Fund's choices for the investment of excess moneys by allowing the board to invest or reinvest in additional investments in the same manner as provided for private insurance carriers. The changes have been reflected in the updated CIC Section 11797 as of January 1, 2011.

Additionally, it was recommended that the Fund: 1) include more specific guidance relating to these areas in the investment policy, as well as providing written confirmation of any supplemental instructions and 2) review its investment policy on an annual basis, and present the policy to the Board of Directors for approval. The Fund has complied with these recommendations.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 21): It was recommended that the Fund redistribute its carried reserves by accident year in order to eliminate the significant deficiencies and redundancies by accident year. The Fund has complied with this recommendation.

It was also recommended that the Fund implement procedures to address the significant delay in processing its medical bill claims. The Fund has complied with this recommendation.

Comments on Financial Statement Items – Commissions Payable, Contingent Commissions and other Similar Charges (Page 23): It was recommended that the Fund delegate the responsibility of accounts payable accruals, such as the accrual for commissions payable, to the Fiscal Department. Additionally, it was recommended that the Fund (1) implement controls to ensure that business functions are reviewed by the Fiscal Department to make certain there is appropriate accounting treatment and (2) establish proper internal controls to ensure that liabilities of the Fund are identified and accrued in the proper accounting period. The Fund has complied with these recommendations.

Comments on Financial Statement Items – Other Expenses (Page 24): It was recommended that the Fund delegate the responsibility of accruals for the group administration fees to the Fiscal Department. Additionally, it was recommended that the Fund implement controls to ensure that business functions are reviewed by the Fiscal Department to ensure appropriate accounting treatment. The Fund has complied with these recommendations.

Comments on Financial Statement Items – Provision for Reinsurance (Page 25): It was recommended that the Fund implement controls to ensure that the provision for reinsurance is calculated in compliance with Annual Statement instructions. The Fund has complied with this recommendation.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Fund's directors, officers and employees during the course of this examination.

Respectfully submitted,

Gordon M Curtis

Gordon M. Curtis, CFE, CISA
Examiner-In-Charge
Department of Insurance
State of California