STATE COMPENSATION INSURANCE FUND

Statutory Basis Financial Statements

(With Independent Auditors' Report Thereon)

December 31, 2011 and 2010

KPMG LLP
Suite 1400
55 Second Street
San Francisco, CA 94105

Independent Auditors' 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 as of December 31, 2011 and 2010, 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 the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 2 to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the California Department of Insurance, which practices differ from U.S. generally accepted accounting principles. The effects on the financial statements of the variances between the statutory accounting practices and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of State Compensation Insurance Fund as of December 31, 2011 and 2010, 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 surplus of State Compensation Insurance Fund as of December 31, 2011 and 2010, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 2.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The supplementary information included on the supplemental investment risk interrogatories, supplemental summary investment schedules, and reinsurance interrogatory is presented for purposes of additional analysis and is not a required part of the financial statements, but is information required to be presented. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

KPMG LLP

May 30, 2012

STATE COMPENSATION INSURANCE FUND

Statements of Admitted Assets, Liabilities, and Policyholders' Surplus
(Statutory Basis)

December 31, 2011 and 2010

(In thousands)

Admitted Assets		2011	2010
Bonds, at amortized cost	$	18,940,254	18,381,870
Real estate		360,189	384,349
Cash, cash equivalents and short-term investments		130,128	1,027,286
Receivables for securities		598	2,839
Total cash and investments		19,431,169	19,796,344
Premiums in the course of collection		27,027	28,212
Deferred, earned but unbilled and accrued retrospective premiums		33,457	35,636
Reinsurance recoverables		5,319	8,397
Accrued interest and dividends		166,707	161,382
Guaranty fund receivables		96,934	122,476
Due from adjusting contracts		39,206	32,415
Other assets		73,086	86,992
Total admitted assets	$	19,872,905	20,271,854
Liabilities and Policyholders' Surplus			
Estimated liabilities for:			
Losses	$	11,996,219	13,164,864
Loss adjustment expenses		2,307,604	1,887,911
Retroactive reinsurance ceded		(597,041)	(678,244)
Unearned premiums		60,051	68,630
Guaranty fund assessments liability		7,822	6,571
Amounts held in trust liability		63,273	50,375
Other liabilities		372,285	305,384
Total liabilities		14,210,213	14,805,491
Special surplus for retroactive reinsurance		576,256	576,256
Unassigned surplus		5,086,436	4,890,107
Policyholders' surplus		5,662,692	5,466,363
Total liabilities and policyholders' surplus	$	19,872,905	20,271,854

See accompanying notes to statutory basis financial statements.

STATE COMPENSATION INSURANCE FUND

Statements of Operations and Changes in Policyholders' Surplus
(Statutory Basis)

Years ended December 31, 2011 and 2010

(In thousands)

	2011	2010
Net premiums earned	$ 1,001,629	1,135,645
Losses incurred	252,381	850,290
Loss adjustment expenses incurred	928,300	520,832
Underwriting and administrative expenses	401,079	409,149
Total underwriting deductions	1,581,760	1,780,271
Net underwriting loss	(580,131)	(644,626)
Investment income	891,291	921,777
Net realized capital gains	27,945	34,303
Investment expenses	(62,115)	(60,794)
Net investment income	857,121	895,286
Other income (loss):		
Gain on sale of vehicle	7	8
Loss on premiums charged off (net of recoveries)	(97,864)	(79,646)
Income before dividends to policyholders	179,133	171,022
Dividends to policyholders	49,501	—
Net income	129,632	171,022
Policyholders' surplus, beginning of year	5,466,363	5,248,889
Change in nonadmitted assets	61,042	55,057
Change in net unrealized capital gains (losses)	—	(4,276)
Change in provision for reinsurance	5,655	(4,329)
Policyholders' surplus, end of year	$ 5,662,692	5,466,363

See accompanying notes to statutory basis financial statements.

STATE COMPENSATION INSURANCE FUND

Statements of Cash Flows
(Statutory Basis)

Years ended December 31, 2011 and 2010

(In thousands)

		2011	2010
Premiums collected net of reinsurance	$	950,053	1,082,381
Net investment income		875,070	916,042
Recoveries from premiums charged off		13,424	12,545
Benefits and loss related payments		(1,417,949)	(1,530,276)
Other underwriting expenses		(839,191)	(871,806)
Net cash used in operations		(418,593)	(391,114)
Proceeds from investments sold, matured, or repaid:			
Bonds		3,839,048	3,796,512
Real estate		44,774	4
Short-term investments and other		2,241	270
Cost of investments acquired:			
Bonds		(4,425,115)	(2,907,339)
Real estate		(15,870)	(8,861)
Net cash provided by (used in) investments		(554,922)	880,586
Other cash provided		76,357	70,900
Net cash provided by financing and miscellaneous sources		76,357	70,900
Net change in cash, cash equivalents and short-term investments		(897,158)	560,372
Cash, cash equivalents and short-term investments, beginning of year		1,027,286	466,914
Cash, cash equivalents and short-term investments, end of year	$	130,128	1,027,286

See accompanying notes to statutory basis financial statements.

(1) History and Business

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

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The statutory basis financial statements of State Fund have been prepared in conformity with accounting practices prescribed or permitted by the California Department of Insurance (CDI), and in accordance with the National Association of Insurance Commissioners' (NAIC) Accounting Practices and Procedures Manual, to the extent those practices and procedures do not conflict with the California Insurance Code.

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:

- The net amount of all cash accounts is reported jointly and in instances of a net negative cash balance, amounts are reported as a negative asset rather than liability.
- Investment in bonds and short-term investments are carried principally at amortized cost, whereas under GASB such investments would be carried at estimated fair value with changes in fair value reflected in net income.
- Policy acquisition costs, including commissions and premium taxes, are charged to current operations as incurred, whereas related premium income is recognized on a pro-rata basis over the periods covered by the policies. Under GASB, policy acquisition costs would be deferred and amortized to income on the same basis as premium income is recognized.
- Certain assets designated as "nonadmitted assets" are excluded from total assets. These assets, the change in which is credited or charged directly to policyholders' surplus, consist primarily of the following: premiums in the course of collection which remain outstanding over ninety days, plus all related amounts due that have been recorded on those policies; nonoperating system internally developed software costs; 10% of earned but unbilled premiums (EBUB) in excess of collateral specifically held and identifiable on a per policy basis; 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party or collateral, not otherwise used; office furniture and equipment, and prepaid expenses. Under GASB, these assets would be included in total assets to the extent realizable.
- Gains on the retroactive reinsurance contract are recognized in income and established as segregated surplus. GASB requires the gains to be deferred and recognized over the estimated settlement period of the reinsured losses, using either a recovery or interest method.

- Policyholders' dividends are accrued when declared, whereas under GASB they are accrued based on amounts to be paid.
- Fees received for processing the claims of other self-insured State of California departments are netted against loss adjustment expenses, whereas under GASB they are recorded as other income.
- An allocation of rental value to space owned and occupied by State Fund is included in income and expense, whereas it is excluded under GASB.
- The statement of cash flows differs in certain respects from the presentation required by GASB, including the presentation of the changes in cash, cash equivalents and short-term investments, instead of cash and cash equivalents. Short-term investments include securities with maturities, at the time of acquisition, of one year or less. In addition, there is no reconciliation between net income and cash from operations as there would be under GASB.
- A provision for reinsurance is recorded as a liability with a corresponding adjustment to policyholders' surplus for the reinsurance receivable from unauthorized reinsurance carriers with inadequate collateral, and reinsurance recoverable over ninety days, plus all related amounts due that have been recorded on those reinsurance recoverable. Under GASB, such a provision for reinsurance is not recognized.

(b) Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with statutory accounting principles permitted or prescribed by the CDI requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. Among the most significant estimates inherent in these statutory financial statements are the liabilities for losses and loss adjustment expenses [see note 2 (f)], the liabilities for the Company's self-insurance loss and loss adjustment expenses, and State Fund's portion of the pension and other postemployment 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 (i)].

(c) Cash, Cash Equivalents, and Short-Term Investments

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. Short-term investments are those investments when originally acquired had maturities of one year or less.

(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 fair value. Amortization is calculated using the scientific constant yield to worst 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-back securities with inputs from major third party data providers. The models combine the effects of interest rates, volatility, and pre-payment speeds based on various scenario (Monte Carlo) simulations with resulting effective analytics (spreads, duration, convexity) and cash-flows on a monthly basis. Credit sensitive cash flows are calculated using propriety models which estimate future loan defaults in terms of timing and severity. Model assumptions are specific to asset class and collateral types and are regularly evaluated and adjusted where appropriate.

The carrying value for MBS has been determined in accordance with the guidelines of the NAIC. Fair value is primarily determined using a pricing hierarchy starting with a widely accepted third party vendor, followed by external broker/dealers, Bloomberg, analytic modeling and a benchmark to index model.

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, probability of recovery and management's intent and ability to hold the asset.

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.

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.

(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 applies the "Western Accounting Method" in which direct written premium is recognized when billed to the policyholder. Insurance premiums are recognized as earned ratably over the term of the policies, that is, in proportion to the amount of insurance protection provided. The portion of the premiums that will be earned in the future is deferred and reported as 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.

As of December 31, 2011 and 2010, State Fund has no liabilities related to premium deficiency reserves. State Fund considers anticipated investment income when determining the existence of a premium deficiency.

(h) Reinsurance

Reinsurance recoverables on paid losses and LAE are reported as assets. Estimated reinsurance recoverables on unpaid losses and LAE are recognized in a manner consistent with the liabilities related to the underlying reinsured contracts.

(i) 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 (CIGA) and the Department of Industrial Relations (DIR) to protect claimants against insurer insolvencies and administer various aspects of the workers' compensation system. The 2011 and 2010 annual CIGA assessment was 2.559% and 2% respectively of direct written premium. The DIR assessment aggregates to approximately 2.4% and 2.9% of direct written premium for 2011 and 2010, 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 DIR 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 DIR assessments are included in other liabilities. Additional surcharges owed by policyholders are included in guaranty fund receivables and the DIR 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 CIGA for guaranty fund assessments for at least the next year at a rate of 2.285% of future direct premiums written. Based on information currently available, State Fund expects to continue to be obligated to fund CIGA annually, at rates that are determined and announced annually.

Under the U.S. Longshoremen's and Harbor Workers' (L&H) Compensation Act, all carriers and self insurers writing U.S. L&H policies, including State Fund, are required to make payments into a Special Fund based on a pro-rated assessment determined by the Secretary of the U.S. Department of Labor. The Special Fund was created to protect injured employees or their survivors by providing for subsequent injuries as defined by the Act. State Fund recorded a liability of $10,000 and $11,000 included in the "other liabilities" account as of December 31, 2011 and 2010 respectively, for future assessments under the U.S. L&H Compensation Act.

(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 OPEB plans. State Fund is not directly liable for obligations under 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 solely based on assessments computed by CalPERS.

The State's OPEB plan provides medical, prescription drug, and dental benefits (healthcare benefits) to retired statewide employees. The authority for establishing and amending the OPEB plan lies with CalPERS 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 annual OPEB cost is calculated based on the annual required contribution (ARC) of the employer, an amount actuarially determined by the State in accordance with the parameters of GASB No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. 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.

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

Based on information provided to State Fund by the State of California, in the June 30, 2011 actuarial valuation, the individual entry-age normal cost method was used. A pay-as-you go funding scenario was used by the State of California. Under the pay-as-you-go funding scenario, the State is assumed to finance retiree healthcare benefits from assets available in the general fund. The State's actuarial assumptions included a discount rate of 4.5%, and an annual healthcare cost trend rate of 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 2011.

The State's unfunded actuarial accrued liabilities for the pension and OPEB plans are based on a variety of actuarial assumptions as disclosed in the CAFR. Separate actuarial valuations related to State Fund are not available. As a result, the portion of the State's unfunded pension and OPEB liabilities attributable to State Fund is not known, and will change over time.

(k) Income Taxes

State Fund is exempt from income taxation under the Internal Revenue Code. State Fund pays premium taxes to the State of California.

(3) Risk-Based Capital

California law imposes risk-based capital (RBC) requirements on admitted California insurance companies, including State Fund. These RBC requirements set forth a calculation to determine the required levels of policyholders' surplus, and provide certain consequences for failure to meet these requirements. State Fund operates in conformity with the California law imposed for RBC. As of December 31, 2011 and 2010, 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, 2011 and 2010 are as follows:

	2011			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury securities and U.S. government sponsored enterprise securities	$ 3,411,721	293,657	—	3,705,378
Obligations of states and political subdivisions	599,784	73,569	—	673,353
Corporate debt securities	5,026,600	343,157	(17,600)	5,352,157
Special revenue	1,719,267	188,281	(2,979)	1,904,569
Other governments	279,346	22,984	—	302,330
Mortgage-backed securities	7,903,536	562,243	(213)	8,465,566
Totals	$ 18,940,254	1,483,891	(20,792)	20,403,353

	2010			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury securities and U.S. government sponsored enterprise securities	$ 4,282,986	207,156	(1,623)	4,488,519
Obligations of states and political subdivisions	608,561	13,267	(7,843)	613,985
Corporate debt securities	3,583,610	252,715	(323)	3,836,002
Special revenue	1,641,606	42,342	(25,381)	1,658,567
Other governments	260,127	15,867	—	275,994
Mortgage-backed securities	8,004,980	411,836	(14,264)	8,402,552
Totals	$ 18,381,870	943,183	(49,434)	19,275,619

State Fund's mortgage-backed holdings as of December 31, 2011 and 2010 consist solely of securities issued by FNMA, GNMA, FHLMC and other government holdings, as follows:

	2011			
	Amortized cost	**Gross unrealized gains**	**Gross unrealized losses**	**Estimated fair value**
FNMA	$ 2,511,344	162,079	(37)	2,673,386
GNMA	2,085,182	216,189	—	2,301,371
FHLMC	3,307,010	183,975	(176)	3,490,809
Totals	$ 7,903,536	562,243	(213)	8,465,566

	2010			
	Amortized cost	**Gross unrealized gains**	**Gross unrealized losses**	**Estimated fair value**
FNMA	$ 2,791,967	141,585	(3,996)	2,929,556
GNMA	1,905,291	115,935	(3,572)	2,017,654
FHLMC	3,304,730	154,316	(6,696)	3,452,350
Other government	2,992	—	—	2,992
Totals	$ 8,004,980	411,836	(14,264)	8,402,552

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, 2011 and 2010, 33 and 139 securities were in an unrealized loss position, which resulted in an unrealized loss of $20,792 and $49,434, respectively. The unrealized loss position at the end of 2011 was due primarily to the downgrades in credit ratings of some of the major banks in the corporate sector. 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, 2011, 99.79% of all bonds held by State Fund were rated Class 1 by the NAIC. State Fund concluded that the gross unrealized losses of $20,792 as of December 31, 2011 were temporary in nature.

The tables below reflect the summary of temporarily impaired financial instruments as of December 31, 2011 and 2010.

	2011					
	12 months or under		Over 12 months		Total	
	Amortized cost	Gross unrealized losses	Amortized cost	Gross unrealized losses	Amortized cost	Gross unrealized losses
Corporate debt securities	$ 442,572	(17,600)	—	—	442,572	(17,600)
Special revenue	29,122	(370)	50,076	(2,609)	79,198	(2,979)
Mortgage-backed securities	49,049	(213)	—	—	49,049	(213)
Totals	$ 520,743	(18,183)	50,076	(2,609)	570,819	(20,792)

	2010					
	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	$ 119,913	(1,623)	—	—	119,913	(1,623)
Obligations of states and political subdivisions	207,813	(7,060)	9,500	(783)	217,313	(7,843)
Corporate debt securities	24,752	(323)	—	—	24,752	(323)
Special revenue	572,869	(11,589)	137,604	(13,792)	710,473	(25,381)
Mortgage-backed securities	787,571	(14,264)	—	—	787,571	(14,264)
Totals	$ 1,712,918	(34,859)	147,104	(14,575)	1,860,022	(49,434)

The amortized cost and estimated fair value of bonds as of December 31, 2011, 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.

	2011	
	Amortized value	Estimated fair value
Due in one year or less	$ 1,529,152	1,552,387
Due after one year through five years	3,997,946	4,285,711
Due after five years through ten years	4,267,041	4,691,592
Due after ten years	1,242,578	1,408,097
Mortgage-backed securities	7,903,537	8,465,566
Totals	$ 18,940,254	20,403,353

Proceeds from sales and redemptions of investments in bonds during 2011 were $3,839,049 with gross realized gains of $13,745 and gross realized losses of $52.

The amortized cost and estimated fair value of bonds as of December 31, 2010, 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.

	2010	
	Amortized value	**Estimated fair value**
Due in one year or less	$ 1,585,554	1,605,622
Due after one year through five years	4,642,340	4,907,102
Due after five years through ten years	2,852,612	3,086,783
Due after ten years	1,296,383	1,273,560
Mortgage-backed securities	8,004,981	8,402,552
Totals	$ 18,381,870	19,275,619

Proceeds from sales and redemptions of investments in bonds during 2010 were $3,796,512 with gross realized gains of $41,390 and gross realized losses of $7,090.

State Fund recognized no other-than-temporary impairment in bonds for the years ended December 31, 2011 and 2010.

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 $66,707 and $67,415 on deposit with the Federal Reserve Bank of Philadelphia 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, 2011 and 2010, respectively.

State Fund does not engage in subprime residential mortgage lending nor does it invest directly in subprime fixed income securities. As of December 31, 2011, State Fund has no direct subprime mortgage related risk exposure. However, State Fund does invest in Aaa/AA+ 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 US 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, 2011 were $185.4 million and represent 0.27% of the total $67.9 billion balance in the State of California's Pooled Money Investment Account. Investments in the PMIA at December 31, 2011 included the following: 18.8% in Loans; 10.8% in Agencies; 50.2% in U.S. Treasuries; 6.1% in

Collateralized Time Deposits; 10.7% in Certificates of Deposit and Bank Notes; 2.8% in Commercial Paper and 0.6% in Mortgages.

(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. State Fund has no assets or liabilities measured at fair value on a recurring basis as of December 31, 2011 and 2010. At December 31, 2011 and 2010, State Fund did not have any material nonrecurring fair value measurement of financial or non financial assets or liabilities carried at fair value, except for certain Real estate properties which was valued at $24,055 on December 31, 2011.

(6) Real Estate, Furniture and Equipment

Real estate as of December 31, 2011 and 2010 is comprised of the following:

		2011	2010
Property occupied by the company	$	439,274	476,138
Property held for sale		10,299	5,623
		449,573	481,761
Accumulated depreciation		(89,384)	(97,412)
Totals	$	360,189	384,349

Depreciation expense on real estate was $9,507 and $9,390 for the years ended December 31, 2011 and 2010, respectively. Certain real estate properties owned were sold and impaired due to significant decrease in appraised value and intent to sell. As of December 2011, State Fund realized a capital gain of $24,555 and a capital loss of $375 for a net realized capital gain of $24,180 on sale of real estate properties. There were no real estate properties sold in 2010. As of December 2011, State Fund impaired real estate properties which resulted in a loss of $9,929 recorded as part of the net realized capital gain (losses). There were no real estate properties impaired in 2010.

Furniture and equipment as of December 31, 2011 and 2010 is comprised of the following:

		2011	2010
Data processing equipment and software	$	114,262	112,502
Office furniture and equipment		199,457	184,158
		313,719	296,660
Accumulated depreciation		(281,029)	(258,880)
		32,690	37,780
Nonadmitted assets		(31,383)	(35,576)
Totals	$	1,307	2,204

Depreciation expense on furniture and equipment was $22,190 and $23,610 for the years ended December 31, 2011 and 2010, respectively.

(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, 2011 and 2010. Loss and loss adjustment expense reserves are shown net of reinsurance but gross of the impact of a loss portfolio transfer.

		2011	2010
Estimated liabilities for losses and loss adjustment expenses as of January 1, net of ceded reinsurance of $232,190 and $239,020, respectively	$	15,052,775	15,728,840
Add incurred related to:			
Current year		998,506	1,092,422
Prior years		182,175	278,700
Total incurred		1,180,681	1,371,122
Less paid related to:			
Current year		78,283	103,753
Prior years		1,851,350	1,943,434
Total paid		1,929,633	2,047,187
Estimated liabilities for losses and loss adjustment expenses as of December 31, net of ceded reinsurance of $170,524 and $232,190, respectively	$	14,303,823	15,052,775

Incurred losses and loss adjustment expenses relating to insured events in prior years were approximately $182,175 and $278,700 in 2011 and 2010, respectively. Increases to prior year incurred are attributable

primarily to the strengthening of loss adjustment expenses, due to a continued decline in closing rates running off claims inventory in face of increasing litigation and Medicare set-aside requirements.

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 (latest Ogilvie/Almaraz Guzman cases), medicare set-aside requirement 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 2005-2011 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, 2011, State Fund identified 1,315 open asbestos cases with aggregate outstanding case reserves of $28,000, or an average outstanding case reserves of approximately $21.3 per claim. At December 31, 2010, State Fund identified 1,289 open asbestos cases with aggregate outstanding case reserves of $25,600, or an average outstanding case reserves of approximately $19.9 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, Berquist-Sherrman adjustment counts and averages, and historical loss ratios adjusted to current rate levels.

The table below reflects the amount paid and reserved for losses and loss adjustment expenses for asbestos claims on direct, assumed and net of reinsurance basis:

		2011	2010
(1) Asbestos, Direct			
a. Beginning reserves (including case, bulk and IBNR, and LAE)	$	57,215	58,257
b. Losses and LAE incurred		4,196	2,960
c. Calendar year payments for losses and LAE		4,768	4,003
d. Ending reserves (including case, bulk and IBNR, and LAE)	$	56,643	57,214
(2) Asbestos, Assumed		—	—
(3) Asbestos, Net			
a. Beginning reserves (including case, bulk and IBNR, and LAE)	$	54,585	55,419
b. Incurred losses and loss adjustment expenses		4,196	3,169
c. Calendar year payments for losses and LAE		4,768	4,003
d. Ending reserves (including case, bulk and IBNR and LAE)	$	54,013	54,585

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 $579,545 and $531,267 as of December 31, 2011 and 2010, respectively. State Fund remains liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities.

Loss reserves eliminated by annuities issued by the following companies exceeded 1% of Policyholder's Surplus as of December 31, 2011 and 2010:

		2011	2010
Genworth Financial	$	95,719	97,465
Hartford Life Insurance		106,943	112,008
Aviva Life Insurance Company		97,896	100,329
Metlife		87,176	59,314
Totals	$	387,734	369,116

(8) Reinsurance

For the years ended December 31, 2011 and 2010, total earned premiums ceded under the reinsurance contracts were $15,801 and $18,709, 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 $170,524 and $232,190 as of December 31, 2011 and 2010, respectively, including $65,549 and $42,087 recoverable from Munich Re America Reinsurance Co. and Reliastar Life Insurance Co as of December 31, 2011, and $71,208 and $58,571 from Munich Re America Reinsurance Co, and Reliastar Life Insurance Co as of December 31, 2010.

In December 2011, State Fund placed a premium deposit equal to two quarters of anticipated insurance premium in a money market account to satisfy the requirements of the 2012 reinsurance agreement.

(a) Catastrophic 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.

In 2011, State Fund was covered for natural catastrophes by per occurrence excess of loss reinsurance treaties for $450,000 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. For terrorism, State Fund was covered by a combination of private reinsurance and the Federal Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA). Above $230,000 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 total limit of $800,000. ($120,000 of coverage).

In 2010, State Fund was covered for natural catastrophes by per occurrence excess of loss reinsurance treaties for $600,000 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. For terrorism, State Fund was covered by a combination of private reinsurance and the Federal Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA). Private reinsurance provided $131,000 of coverage excess of a $300,000 retention on an aggregate annual

basis. Above $260,000 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 $527,000.

(b) Commutation

For the year ending December 31, 2011, State Fund commuted reinsurance recoverable of $29,826 reflected as losses incurred and Loss adjustment expenses incurred amounting to $29,733 and $93, respectively from various reinsurers listed below:

John Hancock Life Insurance Co.	$	4,890
Reliastar Life Insurance Co		7,729
Canada Life Insurance Co		4,891
American National Life Insurance Co		1,915
Excalibur Reinsurance Co		1,594
American United Life Insurance Co *		8,807
Total	$	29,826

* includes commutation on behalf of Pinehurst Pool participants

For the year ending December 31, 2010, State Fund has no commuted reinsurance balances.

(c) Loss Portfolio Transfer (LPT)

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 2011 and 2010.

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 original LPT contained a provision under the "Large Payment Oversight" clause which was intended to address acceleration of payments due to settlement of claims. If the aggregate of Large Payments (defined as individual payments exceeding $10,000 intended to settle future liability) exceeds tabled values in the treaty (as specified at successive year ends), this would void coverage on claims with subsequent Large Payments unless the Reinsurers provide prior written consent for the payments, or State Fund agreed that reimbursement would be apportioned over the life expectancy of the injured employee.

The Large Payment Oversight provision was triggered in the 3rd Quarter of 2009. In order to simplify administration by all parties of this provision, the Company and the Reinsurer amended the original LPT contract to allow the deferral of subsequent Large Payments to be done on the aggregated total for each calendar quarter, based on an agreed average life expectancy for the entire body of claim involved in the LPT.

As of December 31, 2011 and 2010, cumulative subject paid losses were $1,819,982 and $1,707,145, respectively, which exceeded the $950,000 retention. These netted to total billed losses of $782,984 and $681,430 to the Reinsurers (after State Fund's 10% retention) as of December 31, 2011 and 2010, respectively, of which $707,959 and $626,756 were collected from the Reinsurers as of December 31, 2011 and 2010, respectively.

(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, 2011 were as follows:

Year:		
2012	$	29,590
2013		20,567
2014		13,036
2015		5,363
2016		1,833
Future years		7,727
Total	$	78,116

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, 2011 and 2010, the total rental expense for office space was $57,419 and $60,352, respectively, which included an allocation of rental value to space owned and occupied by State Fund of $37,171 and $39,379, respectively. Vehicle and other lease expenses were $15,325 and $20,792 for the years ended December 31, 2011 and 2010, respectively.

Lawsuits arise against State Fund in the normal course of business. Contingent liabilities arising from litigation and other matters are not considered material in relation to the financial position of State Fund.

As of December 31, 2011, State Fund has no irrevocable standby letter of credit. As of December 31, 2010, State Fund's irrevocable standby letter of credit amount to $100.

(10) Retirement and Other Postemployment Benefit Plans

State Fund paid pension expense of $61,601 and $73,249 for the years ended December 31, 2011 and 2010, respectively.

State Fund paid retiree health benefit pro rata assessments of $36,921 and $28,079 for the years ended December 31, 2011 and 2010 respectively. In January 2012, the State provided State Fund's 2011 funding requirements and its related 2011 contribution credit. For the year ended December 31, 2011, the ARC was $119,191. Of this amount, $35,339 was estimated as contributed for 2011. Accordingly, after deducting the estimated contribution of $35,339 and adding the State's ARC adjustment of $1,086, the remaining increase in net OPEB obligation of $84,938 accrued as additional liability for December 31, 2011. In January 2011, the State provided State Fund's 2010 funding requirements and its related 2010 contribution credit. For the year ended December 31, 2010, the ARC was $112,074. Of this amount, $35,242 was estimated as contributed for 2010. Accordingly, after deducting the estimated contribution of $35,242 and adding the State's ARC adjustment of $703, the remaining increase in net OPEB obligation of $77,535 accrued as additional liability for December 31, 2010.

The following table shows the components of State Fund's allocation of the State's 2011 and 2010 OPEB cost, the amount credited to the plan, and changes in the net OPEB obligation as of December 31, 2011 and 2010 are as follows:

		2011	2010
Annual required contribution	$	119,191	112,074
Adjustment to annual required contribution		1,086	703
Annual OPEB cost		120,277	112,777
Estimated contribution credit		(35,339)	(35,242)
Increase in net OPEB obligation		84,938	77,535
Net OPEB obligation beginning of year		305,502	227,967
Net OPEB obligation end of year	$	390,440	305,502

The percentage of annual OPEB costs contributed to the plan was 30% and 31% for 2011 and 2010, respectively.

Based on State Fund's relative payroll compared to total State payroll, State Fund management estimates that State Fund's potential share of the unfunded liabilities for pension plan and OPEB plan as of December 31, 2011 could approximate $1-2 billion. These estimates are subject to considerable inherent uncertainty and the ultimate liabilities could be materially greater than or less than management's current estimates.

(11) Policyholders' Dividends

State Fund declared $50,000 in dividends in 2011. The qualifying policyholders will receive 5.20% of estimated annual premium for the 2011 policy year. State Fund did not declare dividend in 2010.

(12) Risks and Uncertainties

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 whether the AMA Guides must be used as written to dictate permanent disability ratings, [*Almaraz v. SCIF and Guzman v. Milpitas USD*]. These decisions are binding on all Appeals Board panels and Workers' Compensation Judges and affect the 2004 reforms that intended to promote consistency, uniformity and objectivity into the permanent disability rating schedule. Applicant's attorneys may now rebut both the whole person impairment listed within the AMA Guides (*Almaraz/Guzman II*), and/or the DFEC modifier of the 2005 schedule (*Ogilvie*). The decisions apply to all claims with post-1/1/05 dates of injury that are to be rated under the 2005 PDRS and they may result in more expensive permanent disability awards to injured employees, as well as significant increases in litigation costs. Petitions for Writ of Review were filed separately for *Ogilvie*, *Almaraz*, and *Guzman*. In *Ogilvie* the 1st District Court of Appeal affirmed that the DFEC component of the PDRS may be challenged. However, the Court reversed the WCAB's method for challenging the DFEC component. As a result, there is now uncertainty as to what evidence is required to challenge the DFEC *component*. Guzman was upheld by the 6th District Court of Appeal. The 5th District Court of Appeal declined to grant review in *Almaraz*. Furthermore, the Supreme Court denied review in all three cases. State Fund has been monitoring the potential impacts of *Ogilvie / Almarez / Guzman* (OAG). Although average Permanent Disability ratings have increased due to OAG thus increasing cost trends, we feel that much of OAG is already considered in our current case reserves somewhat tempering the potential volatility on ultimate claim values. We will continue to monitor the impact of these decisions on our results.

(13) Related Parties

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 under "Due from adjusting contracts". All agencies make deposits in a trust account that is held by State Fund for future bills. The deposits are reported under "Amounts held in trust liability".

(14) Subsequent Events

Management of State Fund has evaluated all events occurring after December 31,2011 through May 30, 2012, the date the financial statements were available to be issued, to determine whether any event required either recognition or disclosure in the financial statements, noting no such event.

(15) Other Matters

The CDI completed their triennial financial examination on June 15, 2011 of the Company for the years ended December 31, 2007, 2008 and 2009. There were no significant findings.

Schedule I

STATE COMPENSATION INSURANCE FUND

Supplemental Investment Risk Interrogatories

December 31, 2011

(Dollar amounts in thousands)

State Fund's total admitted assets as filed in the 2011 Annual Statement is: $ 19,872,904,690

State Fund's ten largest exposures to a single issuer/borrower/investment:

Issuer	Description of exposure	Amount	Percentage of total admitted assets
Bank of America Corp.	Industrial & Miscellaneous	$ 139,831,938	0.7
JP Morgan Chase & Co	Industrial & Miscellaneous	125,302,641	0.6
Praxair Inc.	Industrial & Miscellaneous	130,466,797	0.7
General Elec Cap Corporation	Industrial & Miscellaneous	143,587,587	0.7
General Dynamics Corp.	Industrial & Miscellaneous	110,913,198	0.6
Southern California Public Power Authority PW	Special Revenue	108,387,679	0.5
Mellon Funding Corporation	Industrial & Miscellaneous	107,934,372	0.5
Goldman Sachs Group, Inc.	Industrial & Miscellaneous	135,913,460	0.7
Morgan Stanley	Industrial & Miscellaneous	118,380,172	0.6
Wells fargo & Company	Industrial & Miscellaneous	130,742,200	0.7

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

Ratings	Amount	Percentage of Total admitted assets
NAIC – 1	$ 18,900,022,848	95.1%
NAIC – 2	40,230,886	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 is less than 2.5% of the total admitted assets.

State Fund's real estate is less than 2.5% of the total admitted assets.

See accompanying independent auditors' report.

Schedule II

STATE COMPENSATION INSURANCE FUND

Supplemental Summary Investment Schedules

December 31, 2011

(Dollar amounts in thousands)

State Fund had the following invested assets as of December 31, 2011:

	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	**Percentage**	**Amount**	**Percentage**
	(in thousands)		(in thousands)	
Bonds:				
U.S. Treasury Securities	$ 1,674,768	8.6%	1,674,768	8.6%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by US government sponsored agencies	1,736,953	8.9	1,736,953	8.9
Non-U.S. Government (including Canada, excluding mortgage-backed securities)	279,346	1.4	279,346	1.4
Securities issued by states, territories and possessions, and political subdivisions in the US:				
States, territories, and possessions general obligations	338,054	1.7	338,054	1.7
Political subdivisions of states, territories and possessions and political subdivisions general obligations	261,729	1.3	261,729	1.3
Revenue and assessment obligations	1,719,267	8.8	1,719,267	8.8
Mortgage-backed securities (includes residential and commercial MBS)				
Pass-through securities:				
Issued or guaranteed by GNMA	1,085,108	5.6	1,085,108	5.6
Issued or guaranteed by FNMA and FHLMC	4,787,502	24.6	4,787,502	24.6
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC or VA	2,030,927	10.5	2,030,927	10.5
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	5,026,600	25.9	5,026,600	25.9
Real estate investments:				
Property occupied by company	354,580	1.8	354,580	1.8
Property held for sale	5,609	—	5,609	—
Receivable for securities	598	—	598	—
Cash, cash equivalents and short-term investments	130,128	0.7	130,128	0.7
Total cash and investments	$ 19,431,169	100.0%	19,431,169	100.0%

See accompanying independent auditors' report.

STATE COMPENSATION INSURANCE FUND

Reinsurance Interrogatory

December 31, 2011

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 (or both parties) to commute the reinsurance contract, whether conditional or not, 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 relative to (2)(f): State Fund has entered into an LPT treaty which includes the following provision: If the aggregate paid Large Payments exceed values in a Cumulative Large Payment Loss Triggers Table, the State Fund will not affect 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.

STATE COMPENSATION INSURANCE FUND

Reinsurance Interrogatory

December 31, 2011

This provision was triggered as of the third quarter of 2011. For administrative convenience State Fund and the reinsurer have agreed that subsequent large loss payments will be recovered from the reinsurer pro rata over an agreed average life expectancy.

(3) State Fund has not, during the period covered by the statement, ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders, where:

(a) The written premium ceded to the reinsurer by State Fund or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to State Fund or its affiliates.

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

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

(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

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

See accompanying independent auditors' report.