APPENDIX B: History, Growth & Financial Condition of State Fund

The State Fund is a division of the Department of Industrial Relations, which operates under the direction of a six member Board of Directors who are appointed by the Governor. The State Fund is managed by an eight member Executive Committee consisting of the President, two Executive Vice Presidents and five Vice Presidents. While there are specific roles and levels of authority within the Executive Committee, significant policy, budget, and appointment decisions are made as a committee.

Currently, the State Fund employs 6,100 people. It is organized into 21 District Offices, 3 Group Insurance Programs, 4 State Contract Adjustment Offices, and 20 Corporate Support Departments. The manager of each of these units reports directly to a designated member of the Executive Committee. This flat organizational structure is intended to maximize the authority and independence of each Program Manager for achieving the goals for his or her operating unit.

The State Fund provides a range of services including sales, underwriting, safety, payroll audit, claims, vocational rehabilitation, and legal defense in each of its 21 District Offices throughout the State of California.

The following table summarizes the staffing of the State Fund:

Table 4

Summary of State Fund Staffing

Year	Total Employees
1986	2,364
1987	2,917
1988	3,731
1989	4,398
1990	5,011
1991	5,419
1992	5,978
1993	6,885
1994	6,775
1995	6,507
1996	6,100

Source: State Fund

Three Group Insurance Programs located in Arcadia, Sacramento, and San Francisco serve the needs of employer associations who want to provide insurance on a group basis for their members. Group insurance provides smaller employers with the incentive to improve safety in the workplace and may lower the cost of their workers compensation insurance through group buying power and through participation in a group dividend calculation. Currently, 22% of the State Fund's total premium is written through group insurance contracts, through over 200 employer trade associations.

The District Offices and Group Programs are supported by centralized services located in the State Fund's headquarters in San Francisco. Home Office functions include data processing, management information, billing, collections, accounting, purchasing, real property management, internal audit, personnel, labor relations, risk management, corporate legal services, training and development, and an audio/video studio.

In addition, each functional specialty; sales, claims, safety, and underwriting, is supported by Home Office departments which are responsible for developing consistent policy and standards for implementation by the District Offices, coordinating systems development in their functional specialty, publishing procedures and operating manuals, and coordinating functional training.

District claims operations are supported by a team of 13 specialists who work on a statewide basis with claimants who have suffered catastrophic injuries such as quadriplegia, paraplegia, organic brain damage, or severe burns. These professionals provide specialized medical and physical rehabilitation and necessary counseling to the families of victims of catastrophic physical impairment.

District safety representatives are supported by a staff of 22 professional industrial hygienists and an accredited industrial hygiene laboratory.

The State Fund also uses and pays for various functions of the State in its operations. The State Fund also pays an allocated share of the overhead for state functions which it does not directly use (e.g. Legislature, State Library, Department of Finance, Bureau of State Audits, etc.). Thus, the State Fund pays some of the overhead of California state government, thereby potentially reducing costs to taxpayers.

The following is a list of estimated budget amounts the State Fund pays to the State:

Table 5

California State Services Rendered to State Fund Cost Estimate

Function	Budget Year (1995/96) Estimate (in dollars)
Finance Audits	59,012
Finance Budgets	10,614
Finance CFIs	23,935
Controller Accounting	14,227
Controller Claims Audits	276
Controller Payroll	82,735
Controller General Disbursements	332
Controller Field Audits	10,680
Controller PPSD(Payroll)SDD(Systems)	695,364
Treasurer Investment	9,425
Treasurer Banking	14,803
Treasurer Cash Mgmt & Trust Services	82,302
State Personnel Board	200,623
Personnel Administration	137,211
Board of Control	1,004
State Library	105,672
Health Benefits for Annuitants (retired)	9,351,686
Legislature	2,368,202
Total	$13,168,103

Source: State Fund

1. MARKET SHARE

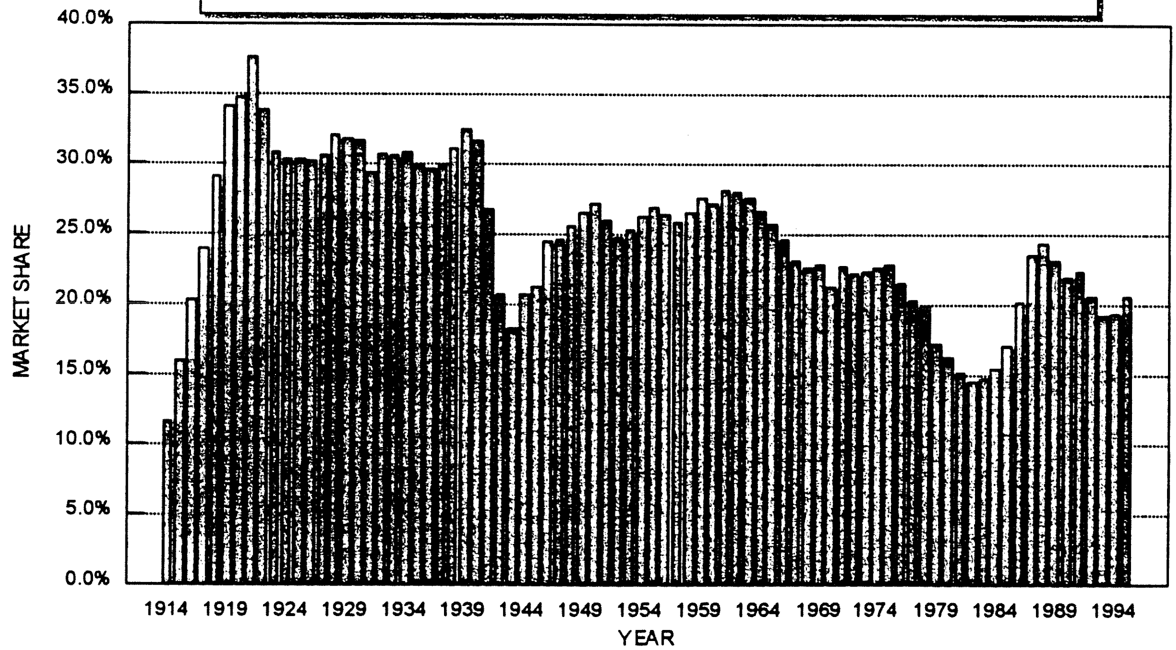
A. Premium

The State Fund is the largest workers compensation insurance writer in California with 1995 direct written premium of $1,044,000,000, or 21% of the total insured California market.

The State Fund is the assured market in California and was created to accept all applicants (excluding applicants failing to comply with requirements). This inability to select from applicants is an important limitation in its ability to compete in the marketplace with insurance companies that can select the classes of employers that they want to write.

The following tables show the history of the State Fund's market share measured as a percent of premium. In 1995, the State Fund wrote 20.6% of California's workers compensation premium. The State Fund's lowest market shares recorded were 14.5% in 1982 and 18.2% in 1943, while the highest market shares were 37.6% in 1921 and 32.5% in 1939. Since 1960, the highest market share was 28.1% in 1961.

GRAPH 1 - STATE FUND MARKET SHARE



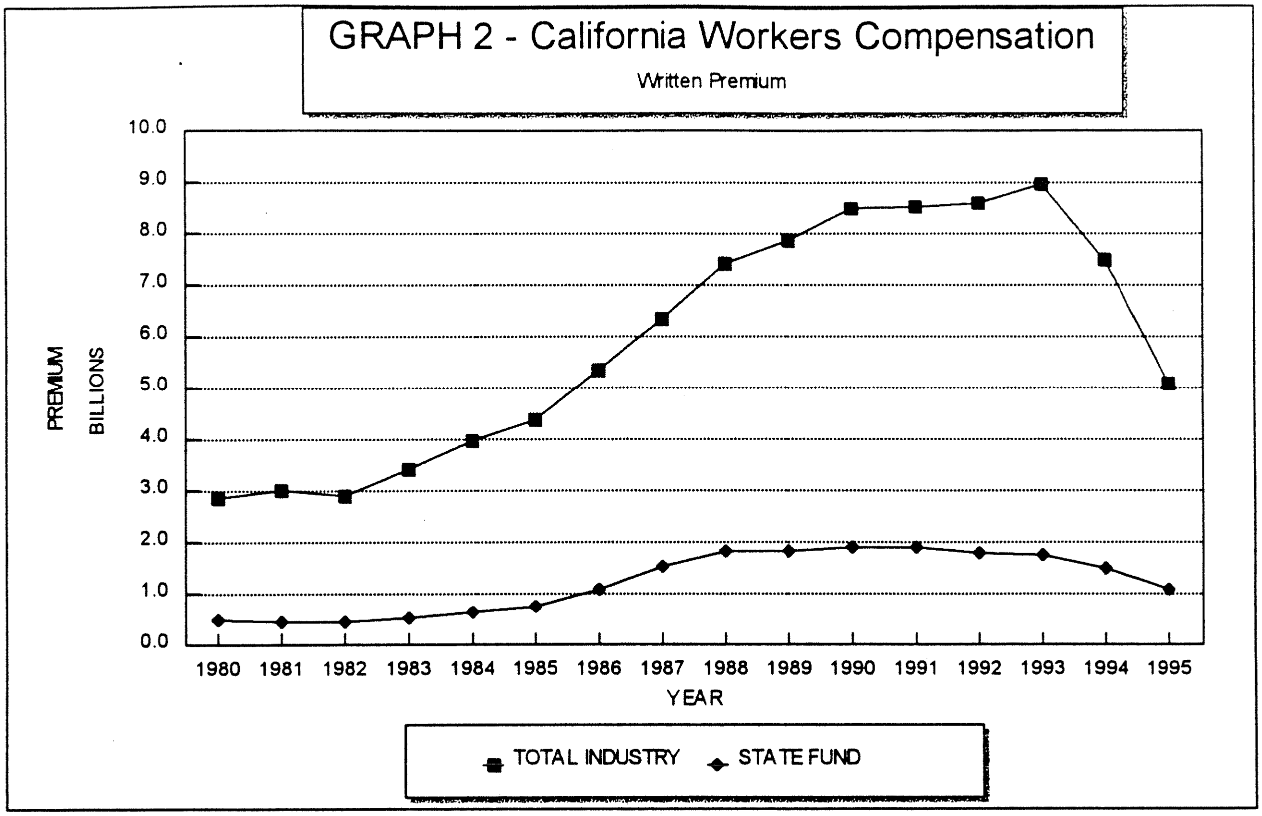
The following table and chart display the State Fund premium written and total statewide premium since 1980:

Table 6

California Workers Compensation - Written Premium
State Fund and Total Industry
($ amounts in 000's)

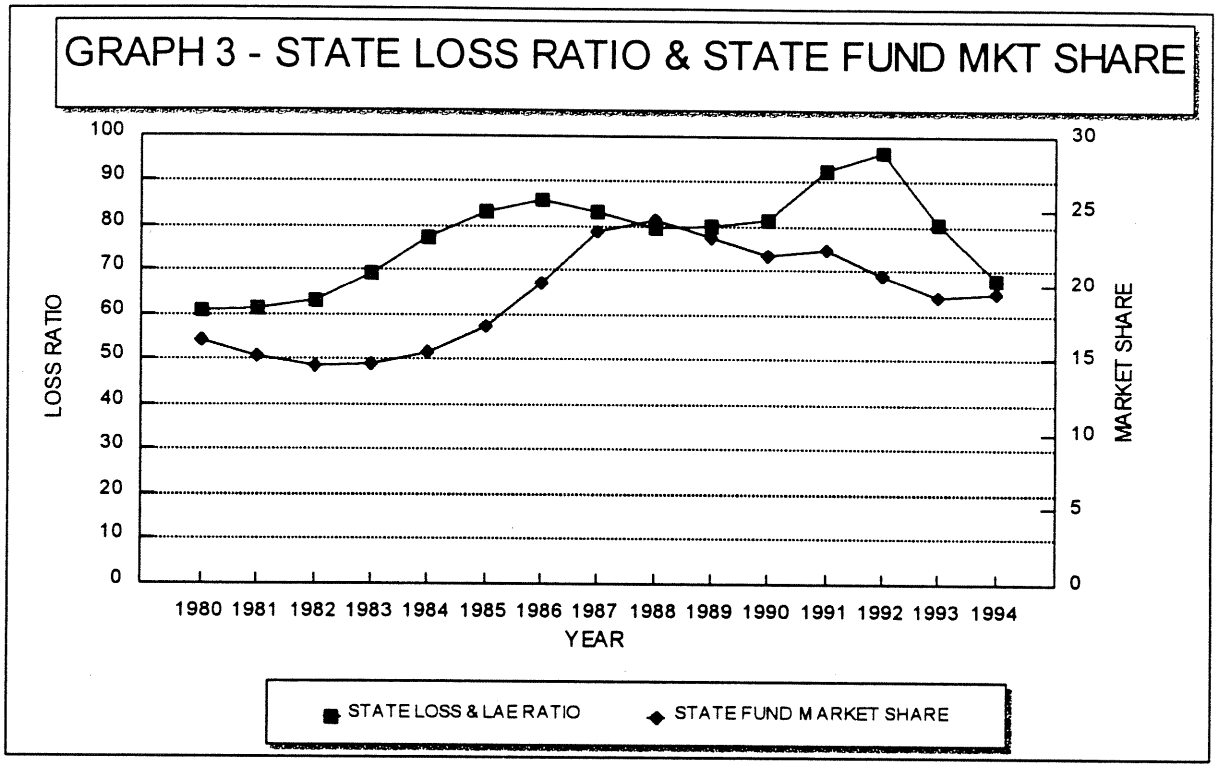
(1) Calendar Year	(2) State Fund Direct Written Premium	(3) Total Industry Direct Written Premium*	(4) (2)/(3) State Fund Market Share
1980	461,726	2,835,617	16.3%
1981	450,458	2,967,995	15.2%
1982	420,229	2,895,100	14.5%
1983	497,211	3,376,743	14.7%
1984	608,243	3,931,246	15.5%
1985	743,465	4,355,885	17.1%
1986	1,070,832	5,321,658	20.1%
1987	1,488,280	6,315,562	23.6%
1988	1,799,691	7,382,808	24.4%
1989	1,819,329	7,855,207	23.2%
1990	1,859,195	8,472,519	21.9%
1991	1,892,521	8,496,640	22.3%
1992	1,767,832	8,575,884	20.6%
1993	1,713,614	8,948,067	19.2%
1994	1,449,033	7,476,945	19.4%
1995	1,044,019	5,061,000	20.6%

Source: State Fund
* Excludes self insurance



GRAPH 2 - California Workers Compensation
Written Premium
PREMIUM
BILLIONS
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995
YEAR
TOTAL INDUSTRY
STATE FUND

The following chart compares the State Fund's market share and the statewide loss ratios:



B. Policy Counts

The State Fund policies in force declined by 4.7% in 1996 compared to 1995 and have declined by 8.6% since 1991. This is in contrast to the 77.3% increase in policies from 1983 to 1991.

In addition to the recent competitiveness of the California workers compensation market, total policies written in the California market have declined by 5.8% over the period 1991 to 1995. While the State Fund's policy count has declined, its statewide market share of premiums in 1995 increased by almost a percentage point.

The following table summarizes the policies in force:

Table 7

California Policies In Force
State Fund and Total Industry

Year Begin 1/1/XX	State Fund Policies In Force	Year to Year % Change	Total Industry Policies In Force	Year to Year % Change
1982	151,307			
1983	148,122	-2.2%		
1984	148,965	+0.5%	503,260	
1985	153,325	+2.9%	457,687	-9.1%
1986	175,024	+14.3%	430,034	-6.0%
1987	208,871	+19.3%	459,057	+6.7%
1988	232,211	+11.1%	N/A	N/A
1989	244,956	+5.4%	571,814	N/A
1990	253,035	+3.2%	575,723	+0.7%
1991	262,655	+3.8%	570,716	-0.9%
1992	259,465	-1.3%	545,018	-4.5%
1993	250,472	-3.5%	531,295	-2.5%
1994	253,212	+1.0%	530,389	-0.2%
1995	251,640	-0.7%	537,489	+1.3%
1996	239,972	-4.7%		

Source: WCIRB and State Fund

As a percent of the total California workers compensation market, the State Fund's share of policies and share of premium is as follows:

Table 8

State Fund Policy Share and Market Share

Year	(Policy Share) State Fund % Share of Policies	(Market Share) State Fund % Share of Premium
1984	29.6%	15.5%
1985	33.5%	17.1%
1986	40.7%	20.1%
1987	45.5%	23.6%
1988	N/A	24.4%
1989	47.6%	23.2%
1990	49.2%	21.9%
1991	49.8%	22.3%
1992	49.8%	20.6%
1993	51.2%	19.2%
1994	47.7%	19.4%
1995	46.8%	20.6%

Source: WCIRB

Although the State Fund's market share has varied over time, there is a large segment of the California workers compensation market that is consistently written by the State Fund. This segment includes the following classes of employers in California:

1. Small employers with premium under $5,000 - the State Fund market share for small employers is in the range of 52% to 58% from policy years 1989 - 1993.
2. Longshoreman's and Harbor Workers Compensation
3. Hazard or higher rated classes

Industry loss ratios by premium size of employers show higher loss ratios for smaller employers. The State Fund insures a disproportionate share of small employers, and records higher loss ratios than the industry in most of the small premium size categories.

Within the State Fund, the 1991 policies are distributed by size as follows (the 1991 year is shown because the data is more mature than more recent years' data):

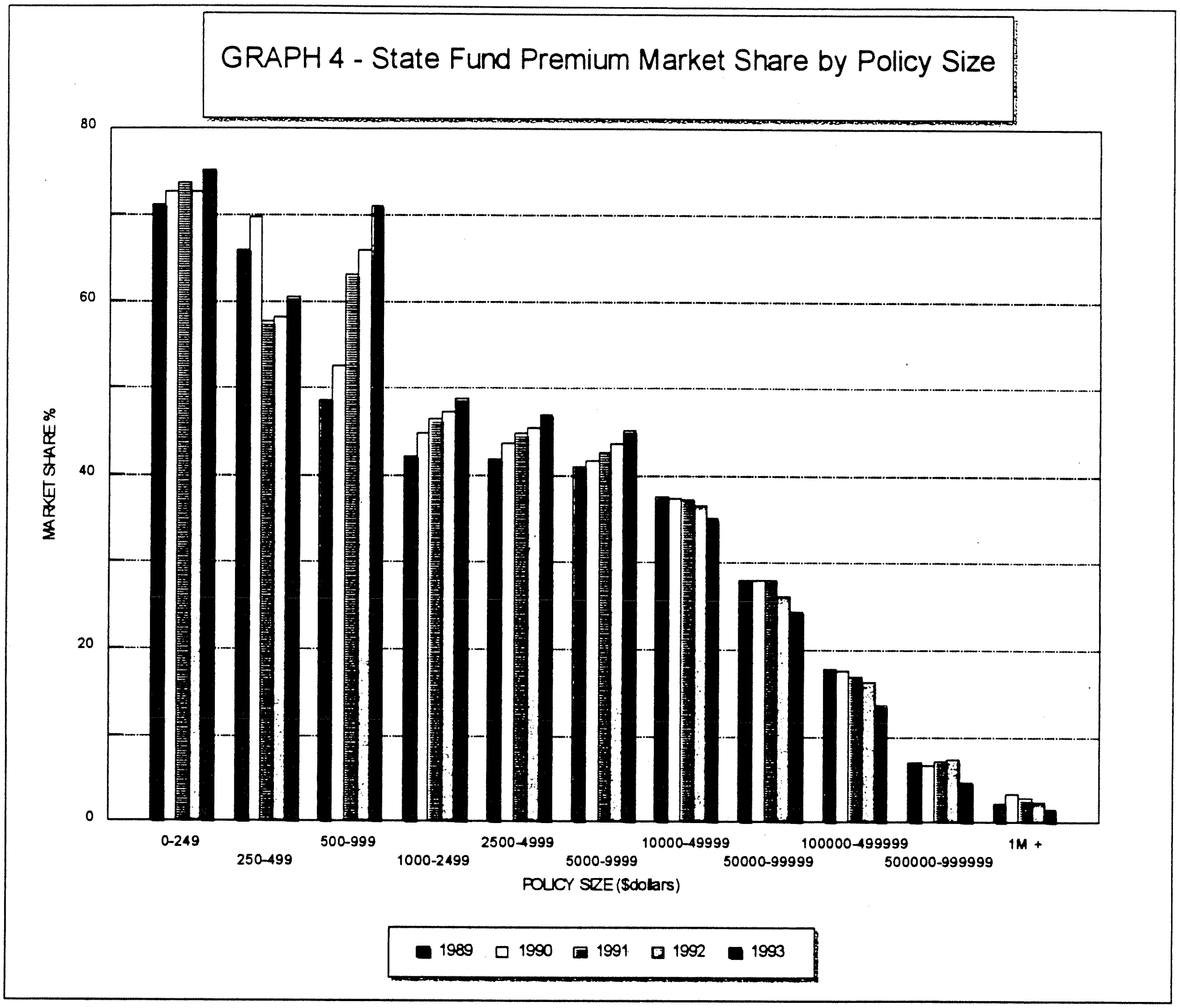
Table 9

Market Share/Loss Experience by Policy Size
1991 Policy Year at 3rd Report

Premium Size	% of Total Policies	State Fund Share of Policies	State Fund Cumulative Policy Share	State Fund Share of Premium	Total Industry* Loss Ratio	State Fund Loss Ratio
0-249	8.2%	70.9%	70.9%	73.7%	108.7%	92.9%
250-499	8.0%	58.1%	64.6%	57.7%	81.3%	93.5%
500-999	18.7%	64.2%	64.4%	63.1%	85.3%	90.2%
1,000-2,499	20.5%	46.5%	57.8%	46.4%	81.1%	98.4%
2,500-4,999	14.0%	44.8%	55.1%	44.8%	76.6%	95.9%
5,000-9,999	11.6%	42.6%	53.3%	42.6%	69.0%	80.7%
10,000-49,999	14.4%	38.8%	51.1%	37.2%	64.6%	72.0%
50,000-99,999	2.4%	28.3%	50.6%	27.9%	65.2%	67.2%
100,000-499,999	1.9%	19.0%	50.0%	16.9%	66.9%	69.6%
500,000-999,999	0.2%	7.3%	49.9%	7.1%	70.7%	72.7%
1,000,000 +	0.1%	4.3%	49.9%	2.9%	70.5%	57.6%
TOTAL	100.0%	49.8%	49.9%	22.0%	68.3%	74.9%

Source: WCIRB, 1991 policy year at 3rd report.
* Total Industry includes State Fund

The following chart further demonstrates the State Fund's market share by policy size over the five year period 1989 - 1993:



2. PRICING AND DIVIDENDS

A. Pricing

Through 12/31/94, most State Fund policies were priced at standard rates promulgated by the Insurance Commissioner; the remaining policies were surcharged due to poor loss history or due to demonstrated unusual hazards. All employers, irrespective of why they insure with the State Fund, are priced on the same basis and participate in the State Fund dividend plans on the same basis.

On January 1, 1995, the long-standing minimum rate law was replaced by open, competitive rating of workers compensation policies in California. Under the old law, the WCIRB rates were the minimum rates and no insurer could charge lower rates. Competition came through payment of policyholder dividends and quality of service.

Under open, competitive rating, the Bureau files advisory loss costs, which only include provision for losses and loss adjustment expenses (these are referred to as loss costs or as pure premiums). Private insurance companies can adopt the Bureau advisory pure premiums, can implement deviation factors, or can file independently derived pure premiums. New schedule rating plans also allow a wide range of credits and debits.

Pricing competition has increased under open rating, as can be seen by the large decrease in premium written in 1995. The marketplace is considered to be extremely competitive. It is unlikely that this intense competition will persist indefinitely, and when financial results deteriorate, history suggests that the State Fund may see an increase in policyholder applicants. The State Fund must be prepared to accept this influx of new business.

Industry written premium has dropped from a high of $8.9 billion in 1993 to $5.1 billion in 1995. This decrease in premium has been attributed to many factors which include a declining economy, the impact of open rating, and reductions in loss costs from fraud prevention legislation and workers compensation reforms.

A recent history of filed statewide rate level changes is as follows:

Table 10

California Rate Level History

Date	Filed Rate Level Change	Actual % Change
July 16, 1993	Flat decrease to all policies in effect	-7.0%
January 1, 1994	Flat decrease to all policies in effect	-12.7%
October 1, 1994	Flat decrease to all policies in effect	-16.0%
January 1, 1995	WCIRB filing for +20%, denied by DOI	0.0%
January 1, 1996	WCIRB filing for +18.7%	+11.3%
January 1, 1997	WCIRB filing for -2.6%	-6.2%

Under open rating, filings are for pure premiums and are advisory only.

As indicated previously, the filed changes for 1995 to present do not reflect the current marketplace prices under open competition which allows a wide range of credits and debits from filed rates.

B. Dividends

The State Fund has historically remained fairly competitive by paying dividends to its policyholders. Despite its higher than average loss ratio, the State Fund has been able to return premium to employers, due in part to its low operating expenses, absence of federal income tax, and non-profit status. Since 1980, the State Fund has paid out over $3.0 billion in dividends to its policyholders. Dividends have varied in recent years from a low of 2.2% of premium in 1977 to a high of 43.1% in 1982. Dividends in 1995 equaled 30.4% of premium.

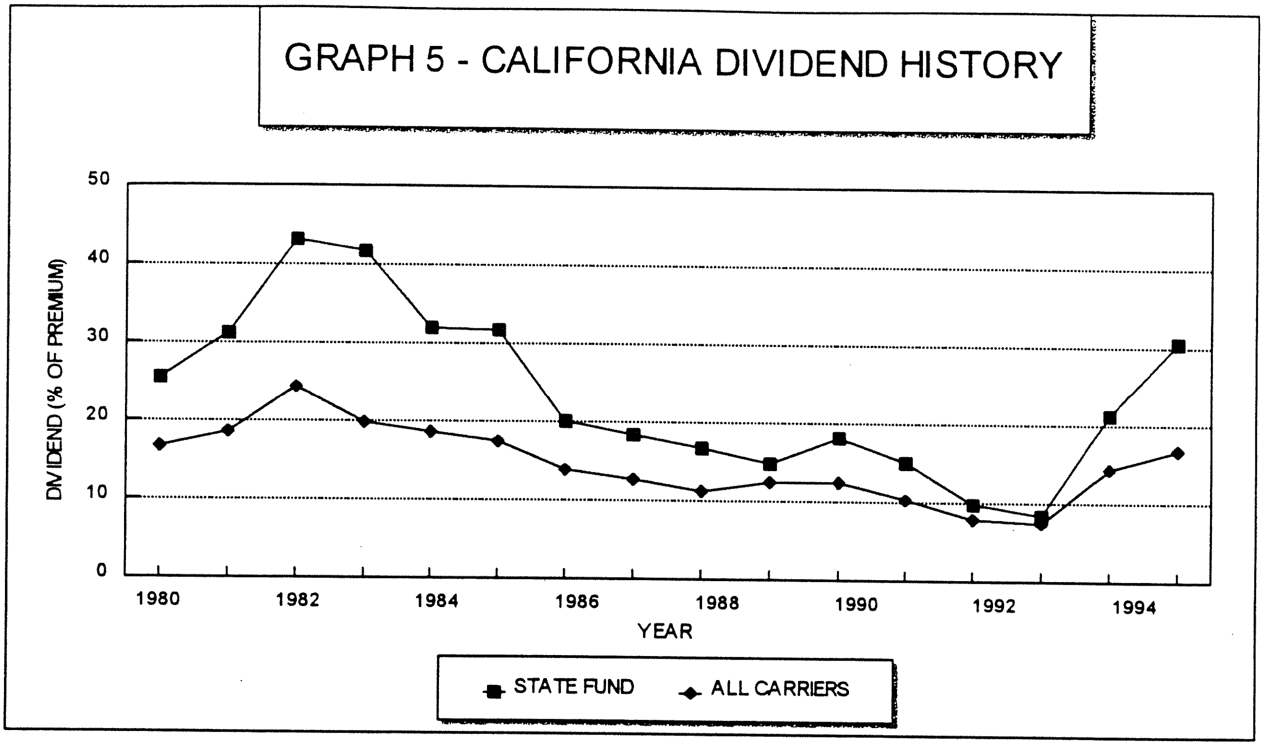
The following charts compare the State Fund dividends versus the workers compensation industry dividends. The State Fund dividends as a percent of premium have historically been higher than the industry in California.

Table 11

Workers Compensation Dividend History - State Fund versus Industry

Year	**State Fund** Dividends (% of Premium)	**Total Industry*** Dividends (% of Premium)
1980	25.4	16.7
1981	31.3	18.7
1982	43.1	24.3
1983	41.7	19.8
1984	31.8	18.6
1985	31.6	17.5
1986	20.0	13.8
1987	18.4	12.7
1988	16.7	11.1
1989	14.7	12.4
1990	18.1	12.4
1991	15.1	10.2
1992	9.7	7.8
1993	8.4	7.4
1994	21.1	14.2
1995	30.4	15.1

Source: State Fund
* Total Industry includes State Fund



For 1994 and prior, insurance companies essentially were using the same rates as the State Fund while the minimum rate law was in effect. The State Fund was able to pay greater dividends to its policyholders.

The State Fund dividend amounts are determined after reviewing the profitability of the prior policy year business and reviewing the financial condition of the State Fund.

3. FINANCIAL PERFORMANCE, RATIOS, EFFICIENCY

A. Operating Results

(1). Premium Growth

Growth in written premium has been quite varied at the State Fund. In the past 15 years, annual premium growth has varied from +44% in 1986 to -28% in 1995. The following table shows direct written premium from 1980 to present. The State Fund written premium has declined from $1.9 billion in 1991 to $1.0 billion written in 1995, a 44% decline in the State Fund premium written. The State Fund premium grew significantly from 1986 to 1988 a period of private insurer withdrawal from the California workers compensation market.

Table 12

Direct Written Premium - California Workers Compensation

State Fund and Total Industry
($ amounts in 000's)

Calendar Year	State Fund Direct Premium Written	Year to Year % Change	Total Industry* Direct Premium Written	Year to Year % Change
1982	420,229		2,895,100	
1983	497,211	+18.3%	3,376,743	16.6%
1984	608,243	+22.3%	3,931,246	16.4%
1985	743,465	+22.2%	4,355,885	10.8%
1986	1,070,832	+44.0%	5,321,658	22.2%
1987	1,488,280	+39.0%	6,315,562	18.7%
1988	1,799,691	+20.9%	7,382,808	16.9%
1989	1,819,329	+1.1%	7,855,207	6.4%
1990	1,859,195	+2.2%	8,472,519	7.9%
1991	1,892,521	+1.8%	8,496,640	0.3%
1992	1,767,832	-6.6%	8,575,884	0.9%
1993	1,713,614	-3.1%	8,948,067	4.3%
1994	1,449,033	-15.4%	7,476,945	-16.4%
1995	1,044,019	-28.0%	5,061,000	-32.3%

Source: State Fund
* Total Industry includes State Fund

The State Fund premium declined in 1995 reflecting improvement in the loss cost environment, the consequent pricing decision of the Insurance Commissioner under the minimum rate law, and the impact of competitive rating in 1995.

(2). Calendar Year versus Accident Year Loss Ratios

Calendar year accounting classifies losses by the date of recognition (or the change in valuation), while accident year assigns losses to the year in which they happened. Accident year loss ratios more clearly indicate a particular year's profitability or unprofitability by correctly matching losses occurring in the year (outgo) with the premiums earned in the particular year (income). For the State Fund, the comparison is as follows:

Table 13

State Fund
Comparison of Calendar Year versus Accident Year Loss + LAE Ratios

Year	Reported Calendar Year Loss+LAE Ratio	Accident Year Loss+LAE Ratio (as of 12/31/95)	Year to Year Change in Accident Year LR
1986	89.1	93.2	-
1987	85.3	83.0	-10.2
1988	87.2	80.0	-3.0
1989	93.7	84.0	+4.0
1990	94.5	101.0	+17.0
1991	104.6	105.3	+4.3
1992	106.7	87.9	-17.4
1993	96.2	73.8	-14.1
1994	71.0	82.8	+9.0
1995	86.9	101.0	+18.2

Source: State Fund Annual Statements

The accident year loss ratios for 1994 and 1995 are much higher than the calendar year loss ratios, as the 1994 and 1995 calendar year operating results have benefited from reserve reductions from older accident years. The implication is that 1994 and 1995 accident year underwriting results are not as favorable as reported calendar year results might indicate.

(3). Expenses

State Fund versus Industry - The following table compares the State Fund expenses to the industry. The State Fund ratios are impacted by the sharp decline in premium written over the past few years. The State Fund's expense ratio is more sensitive to changes in premium than private insurance company expense ratios because a larger proportion of the State Fund expenses are fixed expenses. When premium changes, the expense ratio also changes.

Table 14

California Workers Compensation - Expense History

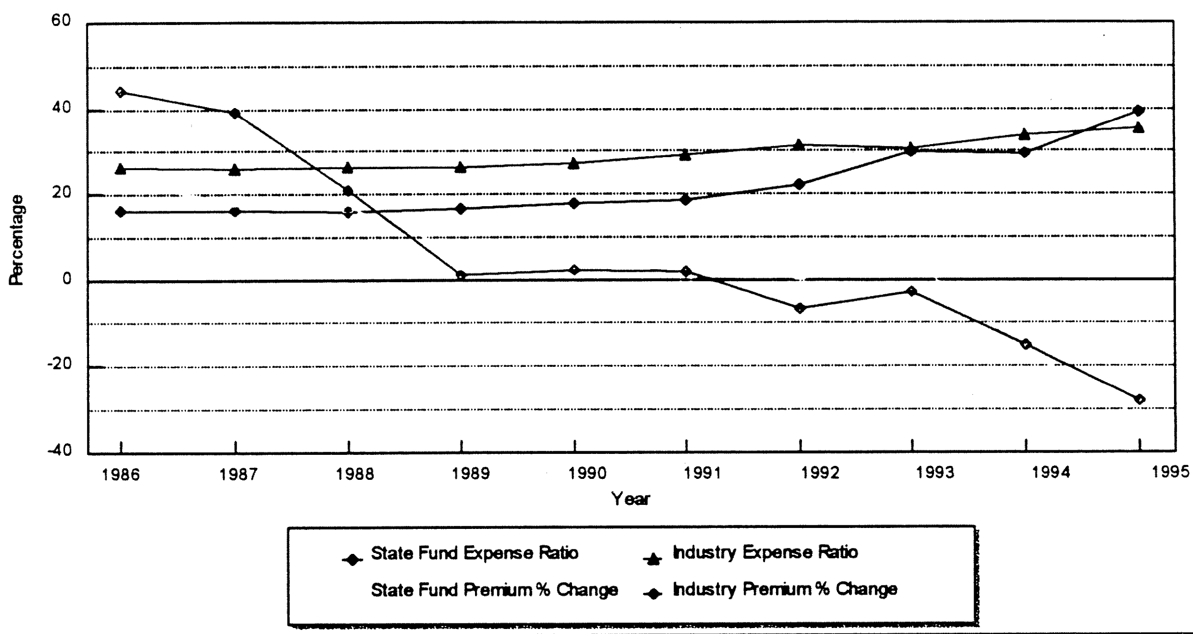
(Expenses as percent of premium)

Year	(1) Private Company Underwriting Expenses	(2) State Fund Underwriting Expenses	(3) (2)-(1) Difference.	(4) Private Company LAE Ratio	(5) State Fund LAE Ratio	(6) (5)-(4) Difference
1986	18.8	7.2	-11.6	9.9	8.8	-1.1
1987	18.3	7.3	-11.0	10.6	9.0	-1.6
1988	18.8	7.2	-11.6	11.1	8.7	-2.4
1989	18.2	7.4	-10.8	11.2	9.0	-2.2
1990	18.5	7.6	-10.9	11.2	10.2	-1.0
1991	18.1	8.9	-9.2	13.6	9.8	-3.8
1992	16.9	10.2	-6.7	17.1	11.8	-5.3
1993	16.4	11.1	-5.3	14.5	18.8	+4.3
1994	19.0	12.6	-6.4	15.8	16.7	+0.9
1995	20.6	17.1	-3.5	13.8	21.9	+8.1

Source: WCIRB and Annual Statement Information
(1),(2): Underwriting expenses include: Commissions & Brokerage, Other Acquisition, General Expenses, and State Taxes
(4),(5): LAE is loss adjustment expense

The following chart demonstrates how the expense ratios for the State Fund and for the industry have risen as premiums have declined significantly in 1994 and 1995:

GRAPH 6 - Expense Ratios and Premium Changes



Expense Growth versus Premium Growth

While the expense ratio has been rising, dollar expenses have actually declined in 1994 and 1995 at the State Fund. The following table summarizes expense growth versus premium growth:

Table 15

State Fund - Premium Growth vs Expense Growth
($ amounts in millions)

Year		Earned Premium	Year to Year Premium % Growth	Expenses	Year to Year Expense % Growth
1986		1,038	+43.2	166	+39.5
1987		1,452	+39.8	237	+42.7
1988		1,773	+22.1	281	+19.0
1989		1,807	+1.9	297	+5.5
1990		1,830	+1.2	326	+9.7
1991		1,870	+2.2	349	+7.3
1992		1,755	-6.2	385	+10.2
1993		1,705	-2.9	510	+32.4
1994		1,456	-14.7	427	-16.4
1995		1,073	-26.4	419	-2.0
	1995 vs 1986		+3.4		+152.2
	1995 vs 1990		-41.4		+28.4

As an insurer expands and writes more business, the expenses for servicing the business (policy issuance, payroll audit, agent acquisition costs, claim investigation, processing, and settlements, etc.) will all increase. Although the opposite is also true, it is more difficult to reduce operating expenses as the number of policies or premium decrease. While 1995 State Fund premium is only 3.4% higher than 1986 premium, the number of policies serviced by the State Fund increased by 43.8%. As the figures in Table 15 indicate, the sharp decrease in premium volume in 1994 and 1995 have resulted in a substantial increase in the expense ratio of 1994 and 1995, although the actual expense dollars have declined in 1994 and 1995.

A comparison of operating expenses in itself can be misleading. Loss control, claims adjustment, utilization review, anti-fraud efforts, and information technology can increase expenses in the short run, but result in lower overall costs if loss ratios are favorably impacted. Also, increasing expenses may relate to increasing levels of service demanded by legislative changes or market demand. Ultimately it is the overall profitability of a company which is important.

(4). Investment Income

Investment income plays a major role in the State Fund's operating results. In the past 20 years investment income has grown from 10% of annual premium to 45% of annual premium in 1995. The State Fund investment income benefits from a high ratio of loss reserves to premium, which rose from 2.24 / 1 in 1990 to 4.29 / 1 in 1995 (See Table 22). However, the absolute level of investment income has declined in 1994 and 1995 as premium and loss reserves have declined.

Table 16

State Fund - Investment Income vs Premium Growth
($ amounts in millions)

Year	Earned Premium	Year to Year Premium % Growth	Invest. Income	Year to Year Inv. Inc. % Growth	Inv. Inc. Ratio
1986	1,038	+43.2	223	+13.9	21.5
1987	1,452	+39.8	239	+7.0	16.5
1988	1,773	+22.1	297	+24.3	16.7
1989	1,807	+1.9	371	+24.8	20.5
1990	1,830	+1.2	420	+13.3	23.0
1991	1,870	+2.2	456	+8.5	24.4
1992	1,755	-6.2	487	+6.7	27.7
1993	1,705	-2.9	531	+9.0	31.1
1994	1,456	-14.7	501	-5.6	34.4
1995	1,073	-26.4	489	-2.4	45.6

Source: Provided by State Fund

(5). Cash Flow

The following is the cash flow from the State Fund's 1995 Annual Statement. The State Fund cash flow was negative in 1995. This was due to the substantial decrease in premium collected in 1995 without a commensurate decrease in paid losses and expenses. Cash flow from operations was positive in the preceding years.

Table 17

State Fund Cash Flow (amounts in $000's)

Item	1991	1992	1993	1994	1995
Premiums Collected Net	1,878,975	1,827,805	1,766,575	1,474,464	1,072,317
Loss and Loss Adjustment Expenses Paid	1,469,579	1,542,459	1,429,449	1,287,408	1,227,564
Underwriting Expenses Paid	159,350	179,030	187,245	193,042	181,370
Other Underwriting Income (Expenses)	4,930	2,595	7,230	58,061	5,357
Cash From Underwriting	254,976	108,912	157,111	51,984	(333,260)
Investment Income (net)	447,459	453,959	466,018	475,421	473,590
Dividends to Policyholders Paid	282,827	169,675	142,353	306,592	327,013
Net Cash from Operations	419,609	393,195	480,776	220,812	(186,683)

Source: State Fund Annual Statement

(6). Net Profit or Loss

The following is the statement of income from the State Fund's Annual Statements:

Table 18

State Fund Statement of Income
Annual Statement
(amounts in $000's)

Item	1991	1992	1993	1994	1995
UNDERWRITING INCOME					
Premiums Earned	1,870,059	1,755,372	1,705,363	1,455,870	1,072,672
DEDUCTIONS					
Losses Incurred	1,773,619	1,666,180	1,317,772	791,247	697,375
Loss Expenses Incurred	182,759	206,964	321,467	243,156	235,417
Other Underwriting Expenses Incurred	166,395	178,088	188,731	183,889	183,082
Total Underwriting Deductions	2,122,773	2,051,231	1,827,970	1,218,292	1,115,874
Net Underwriting Gain or (Loss)	(252,715)	(295,859)	(122,607)	237,579	(43,202)
INVESTMENT INCOME					
Net Investment Income Earned	452,797	469,754	488,973	490,977	484,304
Net Realized Capitals Gains	3,190	17,356	41,928	10,288	4,828
Net Investment Gain or (Loss)	455,987	487,110	530,901	501,265	489,232
Net Income Before Dividends to Policyholders	203,272	191,251	408,294	738,844	446,030
Dividends to Policyholders	282,227	149,275	167,353	339,092	281,513
Net Income After Dividends to Policyholders	(78,955)	41,976	240,941	399,751	164,517

Source: State Fund Annual Statement

The following table shows that the State Fund has operated at a net profit for every year since 1980, with the exception of 1991, if losses, expenses, dividends, and investment income are all included.

Table 19

State Fund Net Operating Profit or Loss
Year End December 31
(amounts in $000's)

(1) Cal. Year	(2) Net Premium Earned	(3) Loss Ratio	(4) Expense Ratio	(5) Comb. Ratio Before Dividend	(6) Dividend Ratio	(7) Comb. Ratio After Dividend	(8) Invest Ratio	(9) Net Profit or Loss
1980	459,419	55.8	16.9	72.7	25.4	98.1	23.1	25.0
1981	446,479	61.3	18.5	79.8	31.4	111.2	29.9	18.7
1982	418,015	62.0	18.7	80.7	43.1	123.8	35.1	11.3
1983	492,199	69.7	16.7	86.4	41.7	128.1	31.2	3.1
1984	601,115	74.4	16.9	91.3	31.8	123.1	29.4	6.3
1985	724,989	78.8	16.4	95.2	31.6	126.8	27.0	0.2
1986	1,038,219	80.3	16.0	96.3	20.0	116.3	21.5	5.2
1987	1,451,486	76.4	16.3	92.7	18.4	111.1	16.5	5.4
1988	1,773,357	78.4	15.9	94.3	16.7	111.0	16.7	5.7
1989	1,807,093	84.7	16.4	101.1	14.7	115.8	20.5	4.7
1990	1,829,618	84.3	17.8	102.1	18.1	120.2	23.0	2.8
1991	1,870,059	94.8	18.7	113.5	15.1	128.6	24.4	-4.2
1992	1,755,372	94.9	21.9	116.8	9.7	126.5	27.7	1.2
1993	1,705,363	77.3	29.9	107.2	8.4	115.6	31.1	15.5
1994	1,455,870	54.3	29.3	83.6	21.1	104.7	34.4	29.7
1995	1,072,672	65.0	39.0	104.0	30.5	134.5	45.6	11.1

Source: State Fund

The calendar year net profit ratios (column 9) are higher in the latest 3 years due to:

1. Favorable loss reserve development resulting in reserve releases in 1993, 1994, and 1995 (reserves impact the numerator of the net profit ratio).
2. Sharply declining premium (which impacts the denominator of the net profit ratio).
3. Higher investment ratios.

B. Balance Sheet

(1). Assets and Liabilities

Major balance sheet items for the State Fund as of December 31, 1995 were as follows:

Table 20

State Fund Balance Sheet Items

Assets	$7.250 billion
Liabilities	$5.656 billion
Surplus	$1.594 billion

The largest items in each category are:

Assets: Bond investments: $5.726 billion
Liabilities: Reserves for losses and loss adjustment expenses on claims which have occurred but which are to be paid in the future: $4.599 billion

(2). Surplus

Surplus (assets minus liabilities) is needed by insurance companies to support the risk of being in the insurance business. In California, this risk must include the potential for a major catastrophe, such as an earthquake. The State Fund surplus has grown to $1.594 billion as follows:

Table 21

State Fund - Surplus History
($ amounts in 000's)

Year	Surplus Exclude CAT Surplus	CAT Surplus	Total Surplus	Annual % Change
1989	679,077	100,000	779,077	
1990	690,805	100,000	790,805	+1.5%
1991	611,977	100,000	711,977	-10.0%
1992	668,462	100,000	768,462	+7.9%
1993	949,223	100,000	1,049,223	+36.5%
1994	1,345,613	100,000	1,445,613	+37.7%
1995	1,494,256	100,000	1,594,256	+10.2%

Source: State Fund Annual Statement

Catastrophe Surplus - As noted in Table 21, the State Fund has designated $100 million of surplus as Catastrophe Surplus. However, the State Fund recognizes that the entire surplus could be at risk in a major California earthquake.

Exposure to workers compensation losses from an earthquake during working hours in California is a major risk. An insurer, such as the State Fund, with 20.6% market share has a significant share of the earthquake exposure.

Various parties have attempted to quantify the earthquake exposure.

One study estimates workers compensation, life insurance, and medical expenses to be a mean of $4 billion ($5 billion in the 90% case) from a 7.0 magnitude earthquake on the Newport-Inglewood fault in the Los Angeles area at 3 pm on a workday.[5]

Another study from this same source estimates mean insured workers compensation, life insurance, and medical expense losses of $1.4 billion if the 1906 San Francisco earthquake strikes again. The "90% probability of non-exceedance" estimate is $3 billion in this study.[6]

Yet another study, conducted in 1988 by All Industry Research Advisory Council, estimates workers compensation losses in the range of $3.2 - $5.5 billion for a 7.5 magnitude earthquake at 2 p.m. on a weekday on the Newport-Inglewood fault in 1990.[7] E.W. Blanch, a major reinsurance intermediary, recently updated these estimates to a 1996 basis, indicating potential total workers compensation losses in the range of $9.1 - 9.5 billion. At a 20.6% market share, this translates to a $1.9 billion event for the State Fund.

California has recognized the potential for a serious earthquake with the establishment of a property catastrophe fund, the California Earthquake Authority, with expected formation in 1997. Florida and Hawaii have also established property catastrophe type programs to deal with a major catastrophe, and to recognize the fact that the insurance industry has limited capacity to respond to a major catastrophic event.

In this regard it is important to recognize that current approved workers compensation loss costs do not include a catastrophe load. A stable insurance market is dependent on stable loss cost expectations. A major earthquake would radically change the expected loss costs in California as perceived by insurance companies. Private insurance companies as a group would immediately reassess their market strategies vis-à-vis California. There would be an inevitable withdrawal of capacity from the

---

[5] Risk Management Solutions, Inc. (RMS), "What if a Major Earthquake Strikes the Los Angeles Area?", 1995.

[6] RiskManagement Solutions, Inc., "What if the 1906 Earthquake Strikes Again? A San Francisco Bay Area Scenario"

[7] All Industry Research Advisory Council, "Earthquake Losses Under Workers Compensation and General Liability", 1988.

California market until a new consensus view of expected loss costs emerged. The State Fund must have sufficient surplus to absorb both a catastrophic earthquake and a sudden increase in premium writings as other carriers withdraw from the market.

The State Fund purchases catastrophe reinsurance for $290 million excess of the first $10 million of losses. Currently, the reinsurance of $290 million plus the $1.594 billion surplus could cover a one time event of $1.8 billion, but that would render it incapable of continuing in operation without an additional infusion of capital. More realistically, the State Fund could absorb its share of smaller catastrophe losses and not have its capital impaired, but larger catastrophe losses or repeated catastrophe losses would have a greater impact and would reduce capital.

The State Fund's surplus is a critical component of the financial security of its policyholders and of the viability of the workers compensation market in California given the likelihood of a significant earthquake in that region.

Adequacy of surplus - While there are many different measurements of the adequacy of surplus, some are the ratio of premium to surplus and the ratio of loss reserves to surplus.

The State Fund 1995 ratio of premium to surplus was 0.67 / 1 as premium fell due to dramatically improving loss experience and competition. Premium to surplus reached 2.63 / 1 in 1991, and reached 7.62 / 1 in 1975 when the voluntary writers withdrew from the market. Surplus related to premium writings covers the risk that premium levels, which are set in advance of the coverage provided, will be inadequate to cover actual loss and expense experience as it emerges.

The State Fund loss reserve to surplus is another rough measure of surplus adequacy. The State Fund reserve to surplus ratio was 2.88 / 1 at 12/31/95 and was 6.46 / 1 in 1991 and 1992. In 1975 it rose to 12.6 /1. At a 12.6 / 1 reserve to surplus ratio, an 8% understatement of carried loss reserves would render the company insolvent. At a 3 / 1 reserve to surplus ratio, the company could sustain a 33% increase in carried loss reserves before becoming insolvent.

The following table summarizes these ratios:

Table 22

State Fund - Premium to Surplus and Loss Reserves to Surplus

Year	Earned Premium	Surplus	Premium/ Surplus Ratio	Loss Reserves	Reserve/ Surplus Ratio	Reserve/ Premium Ratio
1986	1,038	576	1.80	1,770	3.07	1.71
1987	1,452	627	2.31	2,284	3.64	1.57
1988	1,773	713	2.49	2,916	4.09	1.64
1989	1,807	779	2.32	3,584	4.60	1.98
1990	1,830	791	2.31	4,107	5.19	2.24
1991	1,870	712	2.63	4,596	6.46	2.46
1992	1,755	768	2.28	4,926	6.41	2.81
1993	1,705	1,049	1.63	5,135	4.89	3.01
1994	1,456	1,446	1.01	4,891	3.38	3.36
1995	1,073	1,594	.67	4,599	2.88	4.29

Source: State Fund Annual Statements

Another reason that the State Fund needs adequate surplus is that it does not have the ability to raise capital should its capital shrink at some time in the future.

(3). Loss Reserves

As noted in the section above, the State Fund loss and loss expense reserves at 12/31/95 were $4.6 billion. The State Fund is paying workers compensation benefits to injured workers or their spouses for injuries dating back to 1934.

Reserves represent the funds required on an undiscounted basis to ultimately settle all the claims which have occurred up to 12/31/95. The State Fund believes that its overall reserves are adequate and M&R has reviewed the carried reserves at 12/31/95 and issued an actuarial statement of opinion at 12/31/95 concurring with the State Fund's judgment.

C. Financial Ratings

The State Fund is rated A by Standard and Poors. It is also rated "A" by Demotech, Inc. (their highest rating). The A.M. Best Company does not rate the State Fund or any of the state funds as a matter of policy. The State Fund passed all of the NAIC IRIS ratio tests, and was adequately capitalized according to NAIC risk based capital standards at 12/31/95.