Segment Review
July 9, 2012

State Funds' Net Premiums Written, Surplus Grew in 2011; Signs of Change Ahead

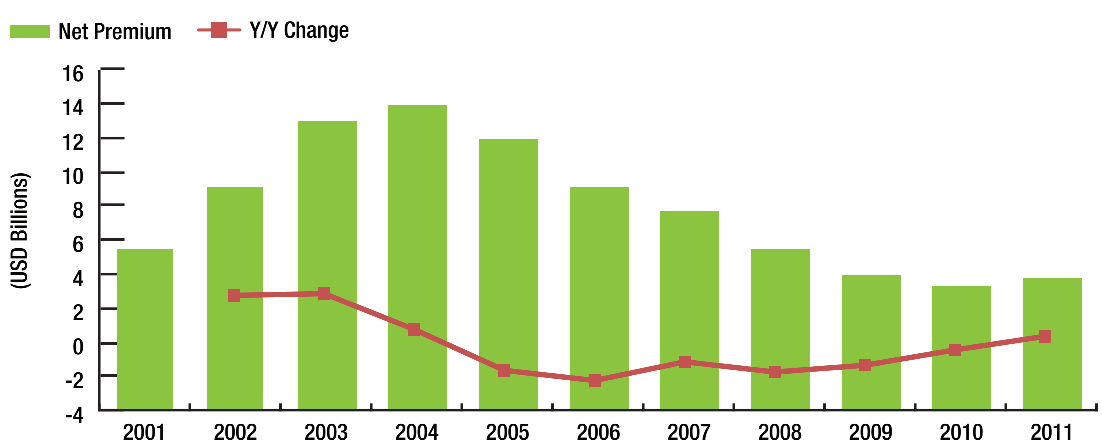
State Funds Notch 7.1% Increase in 2011, Reverse Downward Trend

State funds historically have comprised a significant portion of A.M. Best's U.S. workers' compensation composite. These companies serve their respective states as a guaranteed market and typically provide coverage to companies that experience difficulty obtaining insurance in the general marketplace, with many of the state funds also competing in the broader workers' comp markets in their states. In recent years, amid generally soft conditions in the workers' comp segment, the general market has been more open to writing policies for these companies. As a result of those soft market conditions, net premiums written (NPW) by the state funds declined from 2004 through 2010 (see **Exhibit 1**). In 2011, this trend reversed, with state funds experiencing a 7.1% increase in NPW, which was slightly greater than the increase in A.M. Best's workers' comp composite.

A number of factors led to increased premiums in 2011. Chief among these factors were improved premium audit adjustments; stabilization of employment and payrolls (albeit at a lower level than before the 2008-2009 recession); and particularly as the year progressed, a stronger pricing environment. These factors played a key role in premium increases the state funds experienced. However, as market conditions stabilize and firmer pricing becomes more entrenched, the state funds will see increased demand from employers that no longer can secure affordable coverage elsewhere.

Throughout this report, the term "state funds" is used for the 20 companies listed in **Exhibit 2**. It does not include the monopolistic funds operating in North Dakota, Ohio, Puerto Rico, Washington or Wyoming. Financial information for former state funds (e.g., Brickstreet Mutual Insurance Co.) has been excluded from the historical data presented here.

Exhibit 1
U.S. Competitive State Compensation Funds – Total Net Premium (2001-2011)
Twenty states operate funds that provide workers' compensation coverage. The organizations used in this segment review analysis are listed in **Exhibit 2**.



Source: BestLink – U.S. P/C Statement File

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2011 Financial Results

Based on NPW, 2011 appears to be the beginning of a new cycle for the state funds. NPW for the group increased in 2011 for the first time since 2004. The 7.1% increase was widespread, with NPW improving in all but two states (see **Exhibit 2**). The premium increase for the state funds was slightly higher, on a percentage basis, than the 6.8% increase in the A.M. Best workers' comp composite during 2011.

Exhibit 2

U.S. Competitive State Compensation Funds – Ranked by Net Premium (2011)

Twenty states operate funds that provide workers' compensation coverage.

(USD Millions)

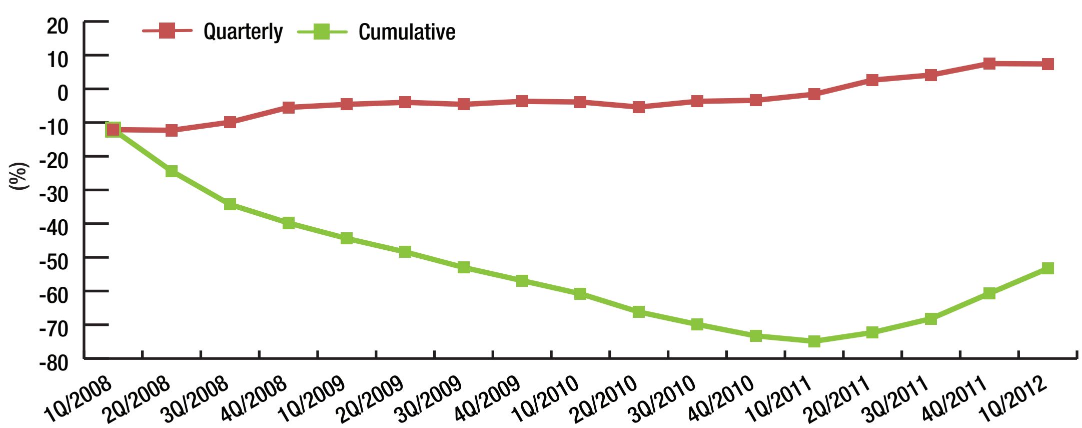
State	Company	2011	Y/Y % Change
N.Y.	State Insurance Fund of New York	$1,495.9	14.2
Calif.	State Compensation Insurance Fund of CA	995.3	-11.2
Texas	Texas Mutual Insurance Co.	741.7	23.2
Colo.	Pinnacol Assurance Co.	382.6	10.3
Ore.	SAIF Corp.	373.0	13.3
Okla.	CompSource Oklahoma	254.6	2.1
Md.	Injured Workers Insurance Fund	176.5	5.8
Ariz.	SCF Arizona	172.8	8.8
Mont.	Montana State Fund	163.9	1.5
Pa.	State Workers' Insurance Fund	156.7	-2.9
Utah	Workers Compensation Fund	156.3	3.2
La.	Louisiana Workers' Compensation Corp.	146.7	6.3
Idaho	Idaho State Insurance Fund	145.9	3.8
Mo.	Missouri Employers Mutual Insurance Co.	139.9	29.4
Maine	Maine Employers' Mutual Insurance Co.	124.0	5.5
Minn.	SFM Mutual Insurance Co.	119.5	13.5
Ky.	Kentucky Employers' Mutual Insurance	112.8	9.6
R.I.	Beacon Mutual Insurance Co.	86.7	6.7
N.M.	New Mexico Mutual Group	61.5	9.1
Hawaii	Hawaii Employers' Mutual Ins Co.	31.1	12.1
	Total	**6,037.5**	**7.1**

Source: BestLink® – U.S. P/C Statement File

Exhibit 3

U.S. Workers' Compensation – Quarterly Change in Price (2008-1Q/2012)

Results from a quarterly survey of agents and brokers show percentage shifts in rate levels for the general workers' compensation segment.



Source: The Council of Insurance Agents & Brokers' Commercial P/C Market Index Survey

A key driver of increased NPW in 2011 was improved premium audit results. During 2009 and 2010, most workers' comp insurers – including the state funds – made substantial returns of premium on audit. This was the result of the precipitous decline in payrolls during the Great Recession of 2008-2009. During 2011, as payrolls stabilized, most companies found audit results also stabilized, with lower return premiums or, in some cases, flat or positive audit results.

Written premiums also were impacted favorably in 2011 by a trend toward higher pricing, the pace of which increased as the year progressed (see **Exhibit 3**). The pace of premium declines had been slowing since the second quarter of 2010, but prices continued to fall until the second quarter of 2011. At that point, price changes turned positive and accelerated through year end. Initially, much of the increase was achieved by reduced use of scheduled debits within rate plans rather than through direct increases in filed rates. However, a number of companies have indicated that they have filed for and received approval of increased rates, which will take effect through 2012.

Net earned premiums at the state funds also increased in 2011, although at a lower rate than written premiums. Earned premiums were up by 3.7% compared with 2010 (see **Exhibit 4**) and are expected to increase at a faster pace in 2012 as the higher priced business written in the later half of 2011 is earned.

Exhibit 4

U.S. Competitive State Compensation Funds – Financial Indicators (2007 - 2011)
(USD Billions)

	2007	2008	2009	2010	2011
Net Premiums Written	$9.065	$7.400	$6.071	$5.636	$6.037
Net Premiums Earned	8.992	7.630	6.253	5.725	5.938
Losses & LAE Incurred	8.000	6.860	6.083	5.686	6.010
Underwriting Expenses	1.762	1.666	1.552	1.467	1.469
Policyholder Dividends	0.780	0.727	0.386	0.512	0.558
Underwriting Income/(Loss)	-1.550	-1.623	-1.768	-1.940	-2.099
Net Investment Income	2.575	2.616	2.454	2.327	2.229
Other Income/(Loss)	-0.056	-0.145	-0.107	-0.234	-0.128
Pre-Tax Operating Income/(Loss)	0.969	0.848	0.580	0.153	0.002
Realized Capital Gains/(Losses)	0.268	-0.722	-0.450	0.739	0.473
Federal Income Taxes	0.011	0.007	0.001	0.010	0.004
Net Income	1.226	0.118	0.129	0.882	0.471

Note: Figures may not add due to rounding.
Source: A.M. Best Co.

Highest Combined Ratio in a Decade

The state fund group's total underwriting loss increased to $2.1 billion last year from $1.9 billion in 2010 (see **Exhibit 4**). Incurred loss and loss-adjustment expenses grew at a faster pace than net premiums earned in 2011, resulting in a higher loss & LAE ratio for the year (see **Exhibit 5**). Higher unallocated loss-adjustment expenses were the main driver of the increase, but a modestly lower level of adverse development of prior accident years' loss reserves also contributed to the higher incurred losses. Underwriting expenses also increased in 2011, but at a slower pace than NPW, resulting in a lower expense ratio.

Exhibit 5

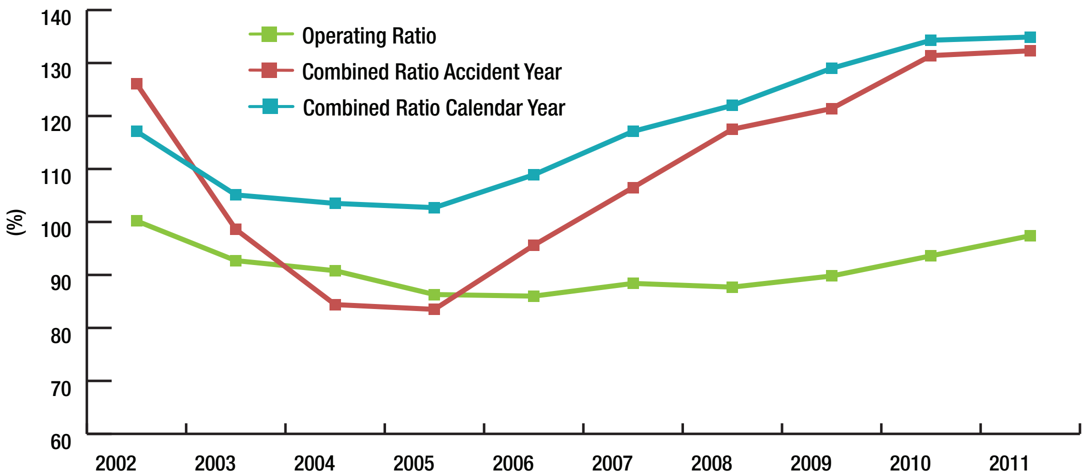
U.S. Competitive State Compensation Funds – Combined Ratio Components (2007-2011)

	2007	2008	2009	2010	2011
Loss & LAE Ratio	89	89.9	97.3	99.3	101.2
Underwriting Expense Ratio	19.4	22.5	25.6	26	24.3
Policyholder Dividend Ratio	8.7	9.5	6.2	9	9.4
Combined Ratio (Calendar Year)	117.1	122	129	134.3	134.9

Note: Figures may not add due to rounding.
Source: A.M. Best research

As a result of these factors, the state funds' calendar-year combined ratio for 2011 hit its highest level in 10 years, measuring 134.9 (see **Exhibit 6**). On an accident-year basis, the combined ratio increased at a slower pace than it has in several years, up less than 1 point from 2010. This marked the smallest increase since the 4.9-point deterioration in 2008.

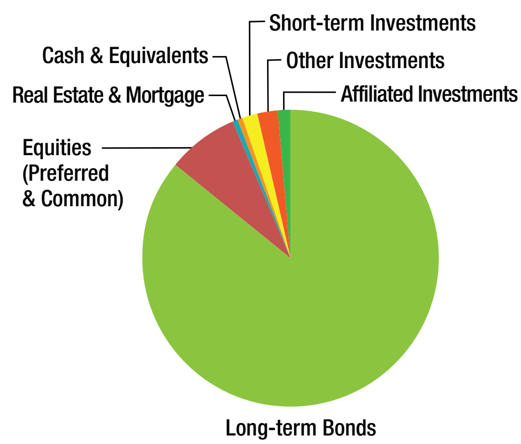
Exhibit 6
U.S. Competitive State Compensation Funds – Combined & Operating Ratios (2002-2011)



Source: A.M. Best research

Net investment income continues to decline, reflecting the same challenging market conditions that have impacted the general property/casualty insurance industry. Long-term bonds represented 86% of the state funds' invested assets at year-end 2011 (see **Exhibit 7**) and were fairly well diversified among U.S. government securities, municipal and government agency issues and corporate bonds. Gross yield on bonds has been declining steadily since 2008 and fell to 4.6% in 2011.

Exhibit 7
U.S. Competitive State Compensation Funds – Invested Assets (2011)



Source: A.M. Best research

Common stock leverage (calculated as a percentage of policyholders' surplus) is modestly elevated for the group as a whole compared with A.M. Best's workers' comp composite, but it has declined in recent years as some companies harvested gains during favorable periods in the market and reduced their equity holdings. Dividends earned increased to $80 million in 2011 from $67 million in 2010, very slightly offsetting the effect of lower bond yields on net investment income.

Despite the declines in underwriting results and net investment income, the state funds as a group posted a modest operating profit of $2.4 million in 2011, down significantly from prior years in the five-year period. Boosted by favorable, but lower, realized gains on the funds' bond and equity holdings, the state funds continued to generate net income. However, net income declined for the first time since 2008, falling to slightly less than $471 million in 2011 from $882 million in 2010.

Net income was modestly offset by the net impact of unrealized capital losses and other surplus gains, producing a 2.2% increase in the state funds' total policyholders' surplus. While still positive, the 2011 surplus growth rate was the lowest since 2008, when surplus declined 8.7% (see **Exhibit 8**).

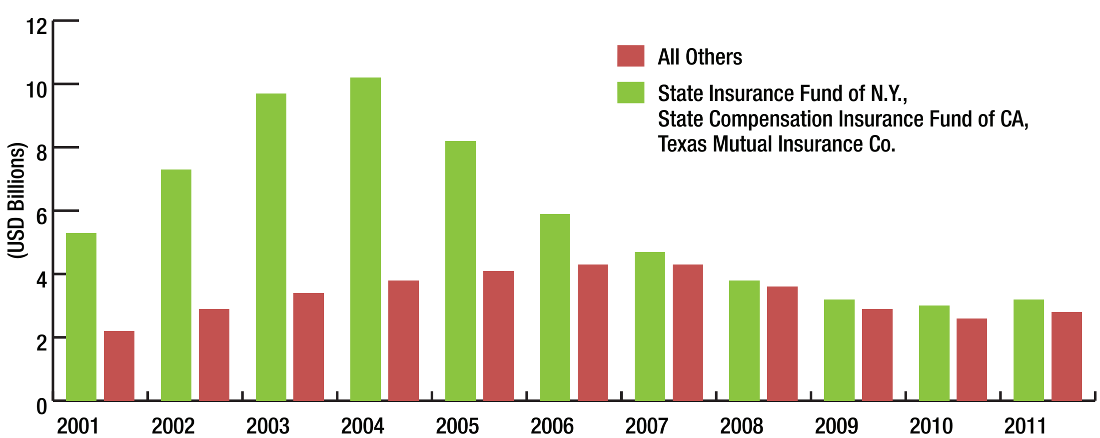
Exhibit 8
U.S. Competitive State Compensation Funds – Change in Policyholders' Surplus (2007-2011)
(USD Billions)

	2007	2008	2009	2010	2011
Beginning PHS at Prior Year End	$12.9	$14.1	$12.9	$14.3	$15.4
Net Income	1.2	0.1	0.1	0.9	0.5
Unrealized Capital Gains/(Losses)	(0.1)	(1.4)	1.3	0.2	(0.2)
Other Changes	0.0	0.1	0.0	0.1	0.1
Ending PHS	**$14.1**	**$12.9**	**$14.3**	**$15.4**	**$15.8**
Change in PHS from Prior Year End	$1.2	-$1.2	$1.4	$1.2	$0.3
Change in PHS from Prior Year End	9.2%	-8.7%	10.9%	8.1%	2.2%
After Tax Return on Surplus (ROE)	8.5%	-9.7%	10.6%	7.3%	1.5%

Note: Figures may not add due to rounding.
Source: A.M. Best research

California Reforms Drive Results
In reviewing the financial results for the state funds group, it should be noted that the state funds in three states – New York, California and Texas – collectively comprised more than 53% of the group's NPW in 2011. Historically, these three companies accounted for as much as much as 74% of the premium of the current group of state funds (see **Exhibit 9**). The decrease in premium at the State Compensation Insurance Fund of California (SCIFCA) has had a significant effect on the group's total NPW.

Exhibit 9
U.S. Competitive State Compensation Funds – Net Premium Growth Among Segment Leaders (2001-2011)



Source: A.M. Best research

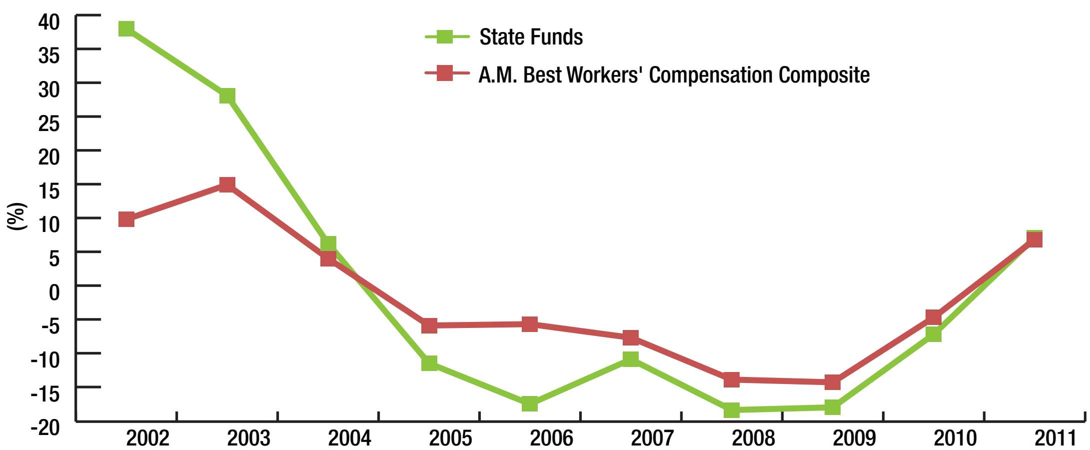
The implementation of significant reforms to California's workers' comp system affected SCIFCA's business in two ways. First, the reforms drove rate reductions that impacted all workers' comp insureds, including those that remained with SCIFCA.

Second, as a result of the reforms, increased capacity in the California workers' comp market made it easier for many companies to secure coverage in the private market. Medical claims costs in California have increased in recent years well beyond the scope of the reforms, which under ordinary circumstances would have led to price pressure and premium increases. But the state's overall economic climate continues to be affected by the housing market's contraction and its subsequent impact on the construction industry, as well as the lingering impact of the 2008-2009 recession, which has held the state's unemployment rate above the national average.

Although market reforms have been implemented in a number of other states during the past 10 years, California's reforms have had a more significant impact on the state funds' collective results because of the size of California's worker' comp market.

The growth and contraction of the state funds has tended to be more pronounced than that of the overall industry because of their function as a guaranteed market. Looking over a 10-year period, the state funds grew much faster than the composite in 2002 and 2003 (as market conditions hardened). The two groups had similar growth rates in 2004, after which premiums at the state funds decreased faster than premiums in the composite, as the market turned and softened. That trend continued until 2011, when both groups grew, but the state funds grew at a very slightly faster pace (see **Exhibit 10**).

Exhibit 10
U.S. Competitive State Compensation Funds – Change in Net Premium (2002-2011)



Note: A.M. Best composite includes competitive state fund data.
Source: A.M. Best research

As market conditions firm and perhaps enter a full-fledged hard market over the next several years, A.M. Best expects the state funds to continue growing at a faster pace than the broad market. Typically during hard market conditions, businesses find it more difficult to secure coverage in the voluntary market and turn to the state funds. While continuing uncertainty regarding the U.S. and global economies makes it difficult to predict how strong the voluntary market's recovery will be in the near term, the pattern of higher and faster growth at the state funds appears set to begin.

Another trend that will impact the state fund group over the near to medium term is privatization. The Arizona and Maryland state funds are set to be privatized in 2013, and discussions continue regarding the potential for other states – including Colorado and Oklahoma – to privatize their funds in the near term. As many of the privatized funds will continue to serve as markets of last resort for some time after privatization, the effects on policyholders and the markets in these states will not be immediately apparent.

Overall, it appears as though 2010 may mark the end of the recent cycle for the state funds. While A.M. Best does not believe a traditional hard market has begun, rate increases and anecdotal reports of reduced business indicate that the stage may be set for a change in the market over the next year. If the past is a good indicator of the future, the state funds are likely to see more significant growth than the rest of the workers' comp industry in 2012.

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