



# WCRA<sup>®</sup>

## *Navigating Challenges*

**Workers' Compensation Reinsurance Association<sup>®</sup>**

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## **2008 ANNUAL REPORT**



## To Our Members

During 2008, your Association's day-to-day operations continued to function smoothly. We issued 2,851 reimbursement checks totaling \$61 million to members, slightly below comparable levels in 2007. Premium income rose to \$48 million. We settled a lawsuit against a member company for \$20 million. All of these factors combined to produce positive cash flow of \$36 million from operations. In the near term, we expect these positive cash flows to continue, which will allow us to meet our ongoing obligations to our members.

Our concern, however, is with the broader economy and the investment markets. As a result of losses in our investment portfolio, we closed the year with a balance sheet deficit of \$424 million. The ultimate cause of this deficit is not our investment returns, which have averaged a healthy 9 percent per year since 1979. The root cause is in regulatory and policy decisions made in the early 1990s.

At that time, our regulators encouraged the WCRA to distribute any large surpluses because it is a nonprofit association and has the ability to assess its members if it incurs substantial deficits. As a result, since 1992, the Association has returned more than \$1.23 billion in surplus distributions to members and to Minnesota workers' compensation policyholders, allowing them to enjoy the benefits of the strong financial results we reported from 1992 to 2000.

Due to these surplus distributions and dramatic declines in the investment markets since 2001, however, your Board of Directors determined at its December meeting that it would likely be necessary to assess all WCRA members as of December 31, 2008, as well as workers' compensation policyholders, to rebuild the Association's capital base. The Board will determine the amount of that assessment in mid-2009. In order to reduce the hardship on members and policyholders, payments of the assessment are expected to be spread over several years and are not likely to begin until January 1, 2010.

We recognize that this assessment comes at a difficult time for our members and policyholders. We will work with our regulators to resolve our current financial challenges and to ensure that we avoid similar problems in the future. We believe, however, that action must be taken now to ensure that the WCRA is able to meet its long-term commitments to both its members and to Minnesota's seriously injured workers.

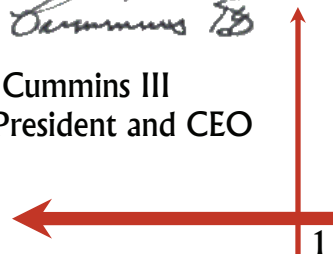
*David R. Young*

David R. Young  
WCRA Board Chair



*Carl W. Cummins III*

Carl W. Cummins III  
WCRA President and CEO





# 2008 Financial Results

## Management's Summary Analysis

### OVERVIEW

The WCRA experienced a very difficult year financially in 2008. The Association recorded a comprehensive loss of \$390 million and a corresponding increase in the balance sheet deficit. At December 31, 2008, the balance sheet deficit was \$424 million, compared to a deficit of \$34 million as of December 31, 2007. The comprehensive loss in 2008 was due primarily to the significant decline in the domestic and international investment markets.

The Board of Directors has a policy objective of maintaining a surplus within a band of +30 percent and -10 percent of the discounted funded loss reserve liability. The December 31, 2008 deficit of \$424 million was -30 percent of funded loss reserves, a significant deterioration from -2 percent of funded loss reserves at December 31, 2007 and well outside the surplus band. Due to the size of the year-end balance sheet deficit, the Board of Directors will consider a deficiency assessment in 2009 for Minnesota workers' compensation policyholders and for WCRA members as of December 31, 2008.

On the positive side, the WCRA had strong cash flow in 2008 and continued to meet all of its financial obligations on a timely basis. Cash flow from operating activities was \$36 million for the year, an increase of \$24 million from 2007. This increase in cash flow was due to a litigation settlement, an increase in premiums received, and a decrease in paid losses.

### OPERATING RESULTS AND COMPREHENSIVE LOSS

#### Premiums and Losses

The WCRA earned \$48 million in funded premiums in 2008, up from \$43 million in 2007. This increase was primarily due to a 15 percent increase in 2008 reinsurance rates.

Funded losses and loss expenses incurred for 2008 were \$74 million, down significantly from \$149 million in the prior year. This decrease was due primarily to actuarial adjustments of prior accident year losses. Prior year loss reserves were reduced by \$100 million in 2008 compared to a reduction of \$4 million in 2007. The significant reduction in prior accident year reserves in 2008 was due primarily to favorable development on case reserves, which resulted in lower projected ultimate losses. The components of discounted funded losses and loss expenses incurred are shown below.

| (\$ millions)                                  | 2008  | 2007  |
|--|-------|-------|
| Prior accident years:                          |       |       |
| Present value update                           | \$ 98 | \$ 92 |
| Actuarial adjustments                          | (100) | (4)   |
| Total prior accident years                     | (2)   | 88    |
| Current accident year                          | 76    | 61    |
| Total funded losses and loss expenses incurred | \$ 74 | \$149 |

## Investment Performance

For the year ended December 31, 2008, the investment portfolio lost 27 percent, the worst loss in the history of the WCRA. This loss was 34 percent below the 7 percent assumed rate of return and the 7 percent return in 2007. In 2008, the investment markets were severely impacted by the global recession, the meltdown in the housing market, toxic mortgage securities, bailouts of financial and auto companies, extreme market volatility, and all-time low liquidity in the credit markets. Returns on domestic and international equities were dramatically lower. In 2008, the WCRA's domestic equities lost 38 percent and international equities lost 45 percent. In 2007, domestic equities returned 7 percent and international equities returned 12 percent. The components of investment results are shown below.

| <i>(\$ millions)</i>                              | <u><b>2008</b></u>    | <u><b>2007</b></u>  |
|---|-----------------------|---------------------|
| Investment income, net of related expenses        | \$ 36                 | \$ 37               |
| Net realized investment (losses) gains            | (148)                 | 62                  |
| Change in unrealized (losses) gains on securities | <u>(270)</u>          | <u>(8)</u>          |
| Total investment results                          | <u><b>\$(382)</b></u> | <u><b>\$ 91</b></u> |

In 2008, the WCRA Investment Policy included asset allocation targets of 40 percent for domestic equities, 20 percent for international equities, and 40 percent for fixed income investments. In 2007, the asset allocation targets were 45 percent for domestic equities, 15 percent for international equities, and 40 percent for fixed income investments.

## Comprehensive Loss

The WCRA recorded a comprehensive loss of \$390 million in 2008, a significant deterioration from the comprehensive loss of \$17 million recorded in 2007. Comprehensive income (loss) consists of net income (loss) and the change in unrealized gains (losses) on investments. In 2008, the comprehensive loss was due primarily to the investment performance, including realized and unrealized investment losses totaling \$418 million. In 2007, the comprehensive loss was due to the excess of current accident year losses of \$61 million over earned premiums of \$43 million. The elimination of a loss reporting backlog resulted in an increase in 2007 losses and a corresponding shortfall in 2007 rates and earned premiums.

## BALANCE SHEET

### Assets and Liabilities

Total assets were \$1,469 million at December 31, 2008 compared with \$1,942 million at the end of the previous year. The decrease in total assets was due primarily to a decrease in investments, including securities lending collateral. In 2008, the Board of Directors approved the termination of participation in the Wells Fargo securities lending program, resulting in a significant reduction in collateral investments and a corresponding reduction in the payables under the securities loan agreement as of year end. This reduction in the liability under the securities loan agreement was the primary reason that total liabilities declined to \$1,893 million at December 31, 2008 from \$1,975 million at December 31, 2007.

The WCRA's largest liability is the reserve for funded losses and loss expenses. This liability totaled \$1,436 million at December 31, 2008 compared with \$1,426 million at December 31, 2007. This liability represents the present value, discounted at 7 percent, of the total estimated obligation for losses and loss expenses for unpaid amounts up to the prefunded limit. Because this liability involves claims that will be paid out over a period of many years, judgments as to the ultimate exposure are an important component of the loss reserving process. Reserves are reviewed on a regular basis using a variety of actuarial techniques. They are

adjusted based on loss experience and as new information becomes available. Changes in the discounted liability for funded losses and loss expenses are shown below.

| <i>(\$ millions)</i>                         | <u><b>2008</b></u>    | <u><b>2007</b></u>    |
|--|-----------------------|-----------------------|
| Funded reserves as of January 1              | \$1,426               | \$1,342               |
| Losses and loss expenses incurred:           |                       |                       |
| Prior accident years                         | (2)                   | 88                    |
| Current accident year                        | <u>76</u>             | <u>61</u>             |
| Total incurred                               | 74                    | 149                   |
| Losses and loss expenses paid                | (61)                  | (65)                  |
| Claims receivable from litigation settlement | <u>(3)</u>            | <u>—</u>              |
| Funded reserves as of December 31            | <u><b>\$1,436</b></u> | <u><b>\$1,426</b></u> |

The components of prior accident year incurred losses and loss expenses are discussed above under “Operating Results and Comprehensive Loss.”

The liability for unfunded losses and loss expenses totaled \$164 million at December 31, 2008, a significant decline from \$183 million at December 31, 2007. This liability represents the present value, discounted at 7 percent, of the total estimated obligation for losses and loss expenses for unpaid amounts in excess of the prefunded limit. The \$19 million decrease in this liability was due to a \$36 million reduction in prior accident year loss reserves. This prior year impact was due to favorable case reserve development. In 2007, the increase in this liability was driven by the present value update and reserves for the current accident year. Unfunded deferred premium revenue of negative \$17 million was recognized in 2008, concurrent with incurred unfunded losses and loss expenses of negative \$17 million. Loss payments in excess of prefunded limits totaled \$1.2 million and \$1.1 million in 2008 and 2007, respectively.

## **Deficit**

At year-end 2008, the WCRA had an accumulated deficit of \$424 million compared with a deficit of \$34 million at the end of 2007. This \$390 million deterioration was due primarily to investment performance and the significant decline in the domestic and international investment markets in 2008. The Board of Directors has a policy objective of maintaining a surplus within a band of +30 percent and –10 percent of the discounted funded loss reserve liability. The December 31, 2008 deficit of \$424 million was –30 percent of funded loss reserves, a significant deterioration from –2 percent of funded loss reserves at December 31, 2007 and well outside the surplus band. Due to the size of the year-end balance sheet deficit, the Board of Directors will consider a deficiency assessment in 2009 for Minnesota workers’ compensation policyholders and for WCRA members as of December 31, 2008.

## **CASH FLOW AND LIQUIDITY**

During 2008, the WCRA had strong cash flow and continued to meet all of its financial obligations on a timely basis. The WCRA has substantial liquidity and the net cash provided by operating activities was \$36 million, an increase of \$24 million from 2007. This increase in cash flow was due to a litigation settlement, an increase in premiums received, and a decrease in paid losses. In addition, the WCRA has a marketable investment portfolio that can provide significant liquidity. Therefore, the WCRA has the overall liquidity necessary to continue to meet its financial obligations on a timely basis for the foreseeable future.



## Board of Directors



*Back row, left to right:*

**Howard Bicker** ■ Minnesota State Board of Investment  
**Robert Ditmore** ■ The Travelers Companies, Inc.  
**Robert Lund** ■ SFM  
**Gary Nelson** ■ Medtronic, Inc.  
**Stuart Henderson** ■ Western National Insurance Group  
**Donald Gerdesmeier** ■ Teamsters Joint Council 32 DRIVE  
**Raymond Waldron** ■ Minnesota AFL-CIO

*Front row, left to right:*

**David Hennes** ■ The Toro Company  
**Katherine Kardell** ■ Minnesota Department of Finance  
**Allison Waggoner** ■ DCI, Inc.  
**Michele Spencer** ■ Ecumen Group Self-Insurance Association  
**David Young, Board Chair** ■ Aon Risk Services



**Wayne Simoneau** ■ Public Representative

The WCRA Board of Directors is responsible for establishing the WCRA's policies and procedures, for overseeing the management of the Association, and for retaining and directing its professional staff. Board membership is drawn from the business community, the insurance industry, organized labor, state government, and the public. State law specifies the composition of the Board, which includes:

- Four insurer representatives elected by insurer members of the WCRA.
- Two self-insurer representatives elected by self-insurer members of the WCRA.
- Two employer representatives appointed by the Commissioner of the Minnesota Department of Labor and Industry.
- Two employee representatives appointed by the Commissioner of the Minnesota Department of Labor and Industry.
- One public representative appointed by the Commissioner of the Minnesota Department of Labor and Industry.
- Commissioner (or designee) of the Minnesota Department of Finance.
- Executive Director (or designee) of the Minnesota State Board of Investment.



## Management and Staff



|  |  |   |  |  |
|--|--|---|--|--|
| <b><u>James A. Heer</u></b><br>Vice President<br>Actuarial | <b><u>Cynthia M. Smith</u></b><br>Vice President<br>Operations | <b><u>Donald J. Swanson</u></b><br>Vice President<br>Finance and<br>Investments | <b><u>Elisabeth M. Skoglund</u></b><br>Vice President<br>Claims and<br>Information Systems | <b><u>Carl W. Cummins III</u></b><br>President and CEO |
|--|--|---|--|--|

■ **James Heer** is responsible for the actuarial functions of the WCRA. He and actuary **Prakash Narayan** establish the premium rates charged to members and estimate the amount of funds the WCRA must hold in reserve to meet future claim payments.

■ **Cindy Smith** manages member premium services, including data reporting, auditing, billing, and general membership. The premium staff's goal is to assure that membership records are current, data submitted by members for calculating premiums is accurate and complete, and membership billings are appropriate and paid on time. Assisting Cindy in these functions are senior premium auditor **Jim Sanem**, premium services assistant **Yvonne Jones**, and member services and financial assistant **Dory Sullivan**.

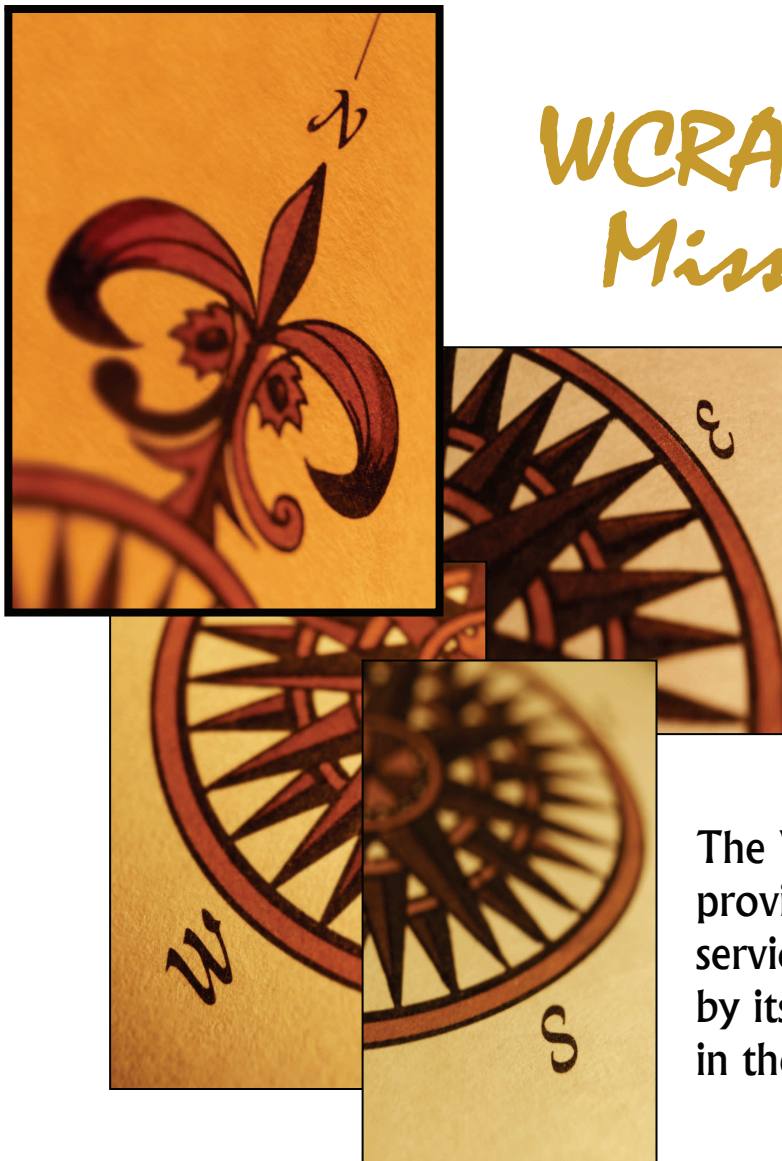
Cindy also serves as the WCRA's corporate secretary and oversees all aspects of the Association's general operations. She is responsible for corporate insurance, human resources, compensation, and training, and is assisted by **Jeanne Mann** in those areas. Administrative staff members **Judy Conley**, **Jodi Elleraas-Burnett**, and **Mary Fraser** also provide support to Cindy in addition to their interface with the claims, finance, and actuarial departments in various capacities.

■ **Don Swanson** is the WCRA's treasurer and manages the finance department of the Association. Don and corporate controller **Lori Thompson** are responsible for the functions of accounting, financial reporting, treasury duties, and investments.

- **Elisabeth Skoglund** leads the claims department and the processing of the primary product that the WCRA delivers to its members—prompt and accurate claim reimbursements. Her staff provides claims and rehabilitation advice on catastrophic injuries and assists members with reserving practices, settlement evaluations, and filing reimbursement requests. The claims department consists of claims account managers **Jane Folsom, Greg Jeans, and Julie Olson**; claims specialists **Ann Dominik, Brandon Milles, and Sherry Staffa**; claims examiner **Dawn Gagnelius**; and catastrophic nurse consultant **Natalie Haefner**.

Elisabeth also directs the WCRA's IS department, which develops, maintains, and supports the Association's computer technology and website. Her IS staff includes manager **Christian King**, administrative assistant **Eva McClellan**, and network administrator **Hasina Akhtar**.

- **Carl "Buzz" Cummins** presides over the Association's management and staff, and reports to the WCRA Board of Directors. He formerly served as the Association's general counsel and retains specific responsibility for managing the WCRA's legal, regulatory, and legislative affairs.



## WCRA Mission

The WCRA ensures the availability of long-term reinsurance protection for serious Minnesota workers' compensation claims. Our staff of innovative professionals is dedicated to achieving the highest standard of excellence through stable and reasonable rates, expert claims administration, and informational services.

## WCRA Vision

The WCRA will provide reinsurance services that are considered superior by its members and other participants in the workers' compensation system.

## Report of Independent Auditors

To the Board of Directors and Members of  
Workers' Compensation Reinsurance Association

In our opinion, the accompanying balance sheets and the related statements of operations, comprehensive income (loss) and accumulated deficit and of cash flows present fairly, in all material respects, the financial position of the Workers' Compensation Reinsurance Association (the "Association") at December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Association's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

*PricewaterhouseCoopers LLP*

February 20, 2009

**Workers' Compensation Reinsurance Association**  
**Balance Sheets**  
**December 31, 2008 and 2007**

| <i>(in thousands of dollars)</i>  | <b>2008</b>  | <b>2007</b>  |
|---|--------------|--------------|
| <b>Assets</b>   |              |              |
| Investments, at fair value  |              |              |
| Cash and cash equivalents   | \$ 121,156   | 39,152       |
| Short-term  | 3,401        | 2,630        |
| Securities lending collateral   | 63,717       | 262,703      |
| Common and preferred stock  | 573,815      | 814,521      |
| Bonds   | 420,441      | 610,497      |
| Total investments   | 1,182,530    | 1,729,503    |
| Uncollected reinsurance premiums  |              |              |
| Current premiums due  | 211          | 520          |
| Deferred for unfunded losses  | 164,633      | 182,954      |
| Total uncollected reinsurance premiums  | 164,844      | 183,474      |
| Accrued investment income   | 3,720        | 4,737        |
| Due from securities brokers   | 117,527      | 23,757       |
| Prepaid expenses and other assets   | 329          | 283          |
| Property and equipment, less accumulated depreciation of \$658<br>and \$738 at December 31, 2008 and 2007, respectively | 99           | 59           |
| Total assets  | \$ 1,469,049 | \$ 1,941,813 |
| <b>Liabilities and Accumulated Deficit</b>  |              |              |
| Liabilities   |              |              |
| Losses and loss expenses  |              |              |
| Funded  | \$ 1,435,549 | \$ 1,426,221 |
| Unfunded  | 164,372      | 183,064      |
| Total losses and loss expenses  | 1,599,921    | 1,609,285    |
| Payable under securities loan agreement   | 76,021       | 263,977      |
| Due to securities brokers   | 215,711      | 99,874       |
| Accounts payable and other liabilities  | 1,091        | 2,054        |
| Total liabilities   | 1,892,744    | 1,975,190    |
| Accumulated deficit from operations   | (290,748)    | (170,479)    |
| Accumulated other comprehensive (loss) income   | (132,947)    | 137,102      |
| Designated accumulated deficit (Note 2)   | (423,695)    | (33,377)     |
| Total liabilities and accumulated deficit   | \$ 1,469,049 | \$ 1,941,813 |

The accompanying notes are an integral part of these financial statements.

**Workers' Compensation Reinsurance Association**  
**Statements of Operations, Comprehensive Income (Loss) and**  
**Accumulated Deficit**  
**Years Ended December 31, 2008 and 2007**

| <i>(in thousands of dollars)</i>  | <b>2008</b>         | <b>2007</b>        |
|---|---------------------|--------------------|
| <b>Revenues</b>   |                     |                    |
| Reinsurance premiums  |                     |                    |
| Funded earned   | \$ 47,523           | \$ 42,775          |
| Unfunded deferred   | (17,467)            | 14,610             |
| Investment income, net of related expenses  | 36,229              | 36,819             |
| Net realized investment (losses) gains  | (148,199)           | 62,169             |
| Litigation settlement income (Note 9)   | 20,000              | -                  |
| <b>Total revenues</b>   | <b>(61,914)</b>     | <b>156,373</b>     |
| <b>Expenses</b>   |                     |                    |
| Losses and loss expenses  |                     |                    |
| Funded  | 73,683              | 148,807            |
| Unfunded  | (17,467)            | 14,610             |
| <b>Losses and loss expenses incurred</b>  | <b>56,216</b>       | <b>163,417</b>     |
| Operating and administrative expenses   | 2,140               | 2,386              |
| <b>Total expenses</b>   | <b>58,356</b>       | <b>165,803</b>     |
| <b>Net loss</b>   | <b>(120,270)</b>    | <b>(9,430)</b>     |
| <b>Other comprehensive loss</b>   |                     |                    |
| Change in net unrealized (losses) gains on securities and foreign<br>currency translation adjustment (Note 3) | (270,048)           | (7,663)            |
| <b>Comprehensive loss</b>   | <b>(390,318)</b>    | <b>(17,093)</b>    |
| Pension benefit obligation (Note 5)   | -                   | (252)              |
| <b>Accumulated deficit, beginning of year</b>   | <b>(33,377)</b>     | <b>(16,032)</b>    |
| <b>Accumulated deficit, end of year</b>   | <b>\$ (423,695)</b> | <b>\$ (33,377)</b> |

The accompanying notes are an integral part of these financial statements.

**Workers' Compensation Reinsurance Association**  
**Statements of Cash Flows**  
**Years Ended December 31, 2008 and 2007**

| <i>(in thousands of dollars)</i>                         | <b>2008</b> | <b>2007</b> |
|--|-------------|-------------|
| <b>Cash flows from operating activities</b>              |             |             |
| Net premiums collected                                   | \$ 47,791   | \$ 43,959   |
| Interest and dividends received, net of related expenses | 36,755      | 36,021      |
| Litigation settlement received (Note 9)                  | 16,614      | -           |
| Losses and loss expenses paid                            | (62,195)    | (65,980)    |
| Operating and administrative expenses paid               | (2,692)     | (1,974)     |
| Net cash provided by operating activities                | 36,273      | 12,026      |
| <b>Cash flows from investing activities</b>              |             |             |
| Sale of investments                                      |             |             |
| Collateral for securities on loan, net                   | 187,956     | (64,292)    |
| Common and preferred stocks                              | 427,357     | 778,798     |
| Bonds  | 2,873,657   | 1,031,002   |
| Purchase of investments                                  |             |             |
| Short-term   | (771)       | (916)       |
| Common and preferred stocks                              | (535,194)   | (743,876)   |
| Bonds  | (2,719,246) | (1,087,315) |
| Purchase of equipment                                    | (72)        | (10)        |
| Net cash provided by (used in) investing activities      | 233,687     | (86,609)    |
| <b>Cash flows from financing activities</b>              |             |             |
| Payable under securities loan agreement                  | (187,956)   | 64,292      |
| Net increase (decrease) in cash and cash equivalents     | 82,004      | (10,291)    |
| <b>Cash and cash equivalents</b>                         |             |             |
| Beginning of year  | 39,152      | 49,443      |
| End of year  | \$ 121,156  | \$ 39,152   |

The accompanying notes are an integral part of these financial statements.

# **Workers' Compensation Reinsurance Association**

## **Notes to Financial Statements**

### **December 31, 2008 and 2007**

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#### **1. General Information**

##### **Description of Association**

In 1979, the Minnesota Legislature created the Workers' Compensation Reinsurance Association (the "Association"), a nonprofit, unincorporated association, to provide reinsurance protection for serious workers' compensation losses to all primary workers' compensation insurance providers and self-insured employers in the state of Minnesota. The Association provides full indemnification to its members for workers' compensation losses paid in accordance with Minnesota Statutes Chapter 176 that exceed a member's retention limit.

Operating procedures are prescribed by Minnesota Statutes Section 79.34-79.40, as amended (the "Enabling Act"), and the Association's Plan of Operation (the "Plan"). Amendments to the Plan must be approved by the Board of Directors of the Association (the "Board") and the Minnesota Commissioner of Labor and Industry.

##### **Membership**

All insurance carriers authorized to underwrite workers' compensation risks in Minnesota and all employers, including political sub-divisions, authorized to self-insure their workers' compensation liabilities in Minnesota are required to be members of the Association.

##### **Retention Limits**

For 2008, members selected one of three maximum per-loss occurrence retention limits, which were \$410,000, \$820,000 or \$1,640,000. For 2007, members selected one of three maximum per-loss occurrence retention limits, which were \$400,000, \$800,000 or \$1,600,000. Retention limits are determined annually based on a formula prescribed in the Enabling Act. Minnesota workers' compensation losses incurred by members in excess of the retention limit selected are reinsured by the Association.

##### **Premiums**

The estimated aggregate annual reinsurance premium billed by the Association to members in each calendar year is calculated to cover the following estimated costs:

- The present value of the estimated ultimate liability for members' incurred losses above the selected retention limit up to and including the prefunded limit of \$8.2 million and \$8.0 million per occurrence for 2008 and 2007, respectively, for funded losses reinsured by the Association.
- Loss payments expected to be made to members for claim amounts in excess of prefunded limits (unfunded losses).
- Operating and administrative expenses of the Association, and loss expenses incurred by the Association. (Loss expenses incurred by members on reinsured claims are not recoverable from the Association.)
- Charges for the current year or a prior year, as determined by the Board, for any reinsurance coverage purchased by the Association.
- Adjustments due to excess or deficient funded premiums, if any, for prior years as determined by the Board.

# **Workers' Compensation Reinsurance Association**

## **Notes to Financial Statements**

### **December 31, 2008 and 2007**

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Estimated reinsurance premiums for each year are billed to the individual members based on: (1) the funded rate for the member's selected retention limit; (2) the rate for expected unfunded payments; and (3) the member's most recent actual exposure base available at the beginning of the annual billing cycle, adjusted for a factor which represents the estimated difference between the member's most recent actual exposure base and the actuarially projected exposure base. In the following year, reinsurance premium adjustments to bring the estimated premiums to actual are calculated and billed or credited to members. In addition, members may be charged for reinsurance purchased by the Association based on: (1) the rate for the reinsurance protection and (2) the member's estimated or actual exposure base for the coverage year of the reinsurance protection.

For insurer members, the exposure base is the earned premium at the designated statistical reporting level reported in the Annual Financial Call for Experience to the Minnesota Workers' Compensation Insurers Association ("MWCIA") multiplied by 1.20. Experience rating modifications of the insurers' individual insureds are reflected in the Annual Call data.

For self-insurer members, the exposure base is calculated from Minnesota's covered payroll, multiplied by pure premium base rates as published by the MWCIA, multiplied by 1.20, multiplied by an experience rating modification factor.

## **2. Summary of Significant Accounting Policies**

### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

### **Risks and Uncertainties**

The Association invests in stocks and bonds of U.S. and foreign companies, U.S. government securities, and mortgage-backed securities. The investment viability and return of funds is dependent on, among other factors, the financial results of the underlying issuers. Due to the level of risk associated with certain investments, it is reasonably possible that changes in the values will occur in the near term and that such changes could materially affect the financial statements.

The process of estimating the liability for losses and loss expenses, by its very nature, involves substantial uncertainty. The level of uncertainty is influenced by factors such as the economic assumptions associated with workers' compensation reinsurance. Ultimate actual payments for losses and loss expenses could be significantly different from the estimates.

### **Comprehensive Income**

The Association follows the reporting concept of "Comprehensive Income" which requires the reporting of comprehensive income in addition to net income from operations. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of certain financial information that historically has not been recognized in the calculation of net income. Comprehensive income for the Association includes net income and other comprehensive income, which includes unrealized gains and losses on available-for-sale securities, the impact of foreign currency translation adjustments on securities denominated in a currency other than U.S. dollars, and the change in the funded status of the defined benefit pension plan.

# **Workers' Compensation Reinsurance Association**

## **Notes to Financial Statements**

### **December 31, 2008 and 2007**

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#### **Cash Equivalents**

Cash on deposit, shares in money market funds, and short-term debt securities with original maturities of three months or less are classified as cash equivalents.

#### **Short-Term**

Debt securities with original maturities greater than three months and less than one year are classified as short term. Amortized cost approximates market value.

#### **Reclassification**

Certain accounts relating to 2007 have been reclassified to conform to the 2008 financial statements.

#### **Investments**

The Association has classified its investments as "available for sale" and carries such securities at fair value. Accordingly, the net unrealized gains or losses are included in other comprehensive income as a separate component of surplus. In determining the realized gain or loss on sales of investments, cost is based on the average cost method. Interest income is recognized when earned. Dividend income is recognized on the ex-dividend date.

Purchased premiums and discounts are amortized or accreted using the straight-line method over the terms of the respective issues. The straight-line method approximates the interest method accounting.

When a decline in value of an investment is determined to be other than temporary, the specific investment is carried at estimated realizable value, and its original book value is reduced to reflect this impairment. Such reductions in book value are recognized as realized investment losses in the period in which they were written down.

The Association has entered into interest-rate future, stock index future, and interest-rate option contracts. Hedge accounting is not used for these contracts. The contracts are valued at market value and account for less than 1% of total investments.

#### **Property and Equipment**

Property and equipment are stated at cost. Depreciation on property and equipment is calculated on the straight-line method over the estimated useful lives of the assets. Upon sale or retirement of property and equipment, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is credited or charged to operations.

#### **Determination of Surplus**

After the close of each fiscal year or at such other times that it deems appropriate, the Board reports whether a surplus or deficit exists based on the annual audited year-end financial statements. In determining whether or not to declare an excess surplus distribution or a deficiency assessment, the Board evaluates surplus or deficit relative to the reserves for discounted funded losses and loss expenses. The Board has determined that up to 30% of the liability for funded losses and loss expenses should be retained and reflected on the balance sheet as designated surplus. Designated surplus is needed to maintain sufficient assets to provide for variations between expected and actual investment returns, variations between expected and actual claims experience, and other unexpected financial developments. The Board will consider a deficiency assessment if the designated accumulated deficit exceeds 10% of the liability for funded losses and loss expenses.

# **Workers' Compensation Reinsurance Association**

## **Notes to Financial Statements**

### **December 31, 2008 and 2007**

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The Board may declare an excess surplus distribution or a deficiency assessment if no such distribution or assessment has been declared in the preceding four years, provided that distributions or assessments may be declared more or less frequently than every five years if the Board, at its sole discretion, determines that it is necessary and prudent to do so. Excess surplus distributions or deficiency assessments may be declared by the Board and distributed to or collected from self-insurer members or policyholders pursuant to the provisions of The Enabling Act and applicable provisions of the Plan.

#### **Reinsurance Premiums**

Funded earned reinsurance premiums are for the calendar year coverage period for funded losses (losses up to and including the prefunded limit). These premiums are billed in the current period. The reinsurance premiums for the calendar year may also include a credit or charge to equitably distribute excess or deficient premiums for previous periods, including any excess or deficient premiums resulting from a retroactive change in the prefunded limit. No excess or deficient premiums were distributed or collected in 2008 or 2007.

Unfunded deferred reinsurance premiums are to be billed in future years for unfunded losses (loss amounts in excess of the prefunded limit) incurred during the calendar year coverage period and are recognized as earned revenue concurrent with the related unfunded losses and loss expenses. Reinsurance premiums for unfunded losses are billed to the members of the Association in the calendar year when payments in excess of prefunded limits are expected to be reimbursed by the Association. The Association began billing for losses in the unfunded layer in 2003. Premiums of \$854,000 and \$780,000 were billed in 2008 and 2007, respectively.

#### **Losses and Loss Expenses**

The liability for funded losses and loss expenses represents the present value, discounted using 7%, of the estimated liability for losses and loss expenses of the Association for unpaid amounts up to and including the prefunded limit, as determined by actuarial projections using historical pricing model simulations and the payment and case reserve experience of the Association.

The liability for unfunded losses and loss expenses represents the present value, discounted using 7%, of the estimated liability for losses and loss expenses of the Association for unpaid amounts in excess of the prefunded limit, as determined by actuarial projections of the Association.

#### **New Accounting Pronouncements**

Effective January 1, 2008, the Association adopted Statement of Financial Accounting Standard ("SFAS") No. 157, *Fair Value Measurement*. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It describes three levels of inputs that may be used to measure fair value:

- Level 1: Quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2: Observable inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly.
- Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value disclosures in Note 7 have been expanded in accordance with SFAS No. 157.

# Workers' Compensation Reinsurance Association

## Notes to Financial Statements

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In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, effective for companies beginning on January 1, 2008. This statement provides entities with an option to report selected financial assets and liabilities at fair value, with the objective to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The adoption of this statement had no impact on the Association's financial statements as the fair value option was not elected for any assets or liabilities held at January 1, 2008.

### 3. Investments

The cost of common and preferred stocks, amortized cost of bonds, and estimated fair values at December 31, 2008 and 2007, are as follows:

| (in thousands of dollars)  | 2008                       |                              |                               |                         |
|--|----------------------------|------------------------------|-------------------------------|-------------------------|
|  | Cost/<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
| Short-term   | \$ 3,404                   | \$ -                         | \$ (3)                        | \$ 3,401                |
| Securities lending collateral  | 66,795                     | -                            | (3,078)                       | 63,717                  |
| Common stocks  | \$ 687,017                 | \$ 24,769                    | \$ (144,757)                  | \$ 567,029              |
| Preferred stocks   | 7,374                      | 208                          | (796)                         | 6,786                   |
| Total stocks   | \$ 694,391                 | \$ 24,977                    | \$ (145,553)                  | \$ 573,815              |
| U.S. Treasury securities and obligations of U.S. government and agencies | \$ 86,315                  | \$ 2,180                     | \$ (5,934)                    | \$ 82,561               |
| Corporate debt securities  | 199,271                    | 9,445                        | (15,716)                      | 193,000                 |
| Mortgage-backed securities   | 143,421                    | 1,614                        | (155)                         | 144,880                 |
| Total bonds  | \$ 429,007                 | \$ 13,239                    | \$ (21,805)                   | \$ 420,441              |

| (in thousands of dollars)  | 2007                       |                              |                               |                         |
|--|----------------------------|------------------------------|-------------------------------|-------------------------|
|  | Cost/<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
| Short-term   | \$ 2,788                   | \$ 2                         | \$ (160)                      | \$ 2,630                |
| Securities lending collateral  | 263,536                    | -                            | (833)                         | 262,703                 |
| Common stocks  | \$ 677,647                 | \$ 156,446                   | \$ (21,628)                   | \$ 812,465              |
| Preferred stocks   | 1,948                      | 108                          | -                             | 2,056                   |
| Total stocks   | \$ 679,595                 | \$ 156,554                   | \$ (21,628)                   | \$ 814,521              |
| U.S. Treasury securities and obligations of U.S. government and agencies | \$ 164,458                 | \$ 8,515                     | \$ (1,292)                    | \$ 171,681              |
| Corporate debt securities  | 243,830                    | 4,558                        | (8,952)                       | 239,436                 |
| Mortgage-backed securities   | 198,790                    | 1,321                        | (731)                         | 199,380                 |
| Total bonds  | \$ 607,078                 | \$ 14,394                    | \$ (10,975)                   | \$ 610,497              |

# Workers' Compensation Reinsurance Association

## Notes to Financial Statements

### December 31, 2008 and 2007

Total unrealized losses were \$170.4 million and \$33.6 million at December 31, 2008 and 2007, respectively. The following tables provide a breakdown of unrealized losses at December 31, 2008 and 2007. The Association has reviewed the components and duration of these unrealized losses and concluded that the losses are temporary in nature. The unrealized losses are primarily on common stocks. The unrealized losses as of December 31, 2008 and 2007, are as follows:

| Unrealized Holding Losses as of December 31, 2008                        |                      |                   |                      |                   |                      |                   |
|--|----------------------|-------------------|----------------------|-------------------|----------------------|-------------------|
| (in thousands of dollars)  | Less than 12 months  |                   | 12 months or more    |                   | Total                |                   |
|  | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses |
| Short-term   | \$ 3,401             | \$ (3)            | \$ -                 | \$ -              | \$ 3,401             | \$ (3)            |
| Securities lending collateral  | 63,717               | (3,078)           | -                    | -                 | 63,717               | (3,078)           |
| Common stocks  | \$ 273,705           | \$ (83,688)       | \$ 106,913           | \$ (61,069)       | \$ 380,618           | \$ (144,757)      |
| Preferred stocks   | 2,280                | (796)             | -                    | -                 | 2,280                | (796)             |
| Total stocks   | \$ 275,985           | \$ (84,484)       | \$ 106,913           | \$ (61,069)       | \$ 382,898           | \$ (145,553)      |
| U.S. Treasury securities and obligations of U.S. government and agencies | \$ 19,764            | \$ (5,747)        | \$ 1,833             | \$ (187)          | \$ 21,597            | \$ (5,934)        |
| Corporate debt securities  | 91,189               | (12,756)          | 17,429               | (2,960)           | 108,618              | (15,716)          |
| Mortgage-backed securities   | 16,884               | (151)             | 774                  | (4)               | 17,658               | (155)             |
| Total bonds  | \$ 127,837           | \$ (18,654)       | \$ 20,036            | \$ (3,151)        | \$ 147,873           | \$ (21,805)       |

| Unrealized Holding Losses as of December 31, 2007                        |                      |                   |                      |                   |                      |                   |
|--|----------------------|-------------------|----------------------|-------------------|----------------------|-------------------|
| (in thousands of dollars)  | Less than 12 months  |                   | 12 months or more    |                   | Total                |                   |
|  | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses |
| Short-term   | \$ 2,371             | \$ (160)          | \$ -                 | \$ -              | \$ 2,371             | \$ (160)          |
| Securities lending collateral  | 255,241              | (833)             | -                    | -                 | 255,241              | (833)             |
| Common stocks  | \$ 269,275           | \$ (21,628)       | \$ -                 | \$ -              | \$ 269,275           | \$ (21,628)       |
| Preferred stocks   | -                    | -                 | -                    | -                 | -                    | -                 |
| Total stocks   | \$ 269,275           | \$ (21,628)       | \$ -                 | \$ -              | \$ 269,275           | \$ (21,628)       |
| U.S. Treasury securities and obligations of U.S. government and agencies | \$ 21,403            | \$ (1,292)        | \$ -                 | \$ -              | \$ 21,403            | \$ (1,292)        |
| Corporate debt securities  | 95,913               | (5,876)           | 46,342               | (3,076)           | 142,255              | (8,952)           |
| Mortgage-backed securities   | 48,021               | (224)             | 31,657               | (507)             | 79,678               | (731)             |
| Total bonds  | \$ 165,337           | \$ (7,392)        | \$ 77,999            | \$ (3,583)        | \$ 243,336           | \$ (10,975)       |

**Workers' Compensation Reinsurance Association**  
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The amortized cost and estimated fair value of debt securities at December 31, 2008, by contractual maturity, are shown below:

| <i>(in thousands of dollars)</i>       | <b>Amortized<br/>Cost</b> | <b>Estimated<br/>Fair Value</b> |
|--|---------------------------|---------------------------------|
| Due in one year or less                | \$ 8,595                  | \$ 10,864                       |
| Due after one year through five years  | 38,168                    | 37,631                          |
| Due after five years through ten years | 34,481                    | 34,179                          |
| Due after ten years                    | 347,763                   | 337,767                         |
|  | <b>\$ 429,007</b>         | <b>\$ 420,441</b>               |

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.

The Association evaluates its investment securities for other-than-temporary impairment on an annual basis. Factors considered in determining whether an impairment is other-than-temporary include: 1) the length of time and the extent to which fair value is less than cost, 2) the financial condition, industry, and near-term prospects of the issuer, 3) adverse changes or events impacting the issuer, and 4) the ability and intent of the Association to hold these investments for a period of time sufficient to collect amounts due according to the contractual terms of the investments or until recovery.

During 2008, the Association made a determination that the decline in the fair value of certain of its investments was other than temporary. As a result of this determination, the cost bases of the individual securities were written down to fair value as the new cost bases, and the total amount of the write-down of approximately \$77.4 million was recorded in earnings as a realized loss. The Association also wrote down \$10.7 million of individual securities to fair value in 2007.

Other comprehensive loss in 2008 and 2007 is comprised of the change in unrealized gains (losses) on available-for-sale securities arising during the year, the impact of foreign currency translation adjustments on securities denominated in currency other than U.S. dollars and the change on the funded status of the defined benefit pension plan as follows:

| <i>(in thousands of dollars)</i>              | <b>2008</b>         | <b>2007</b>       |
|---|---------------------|-------------------|
| Change in net unrealized losses on securities | \$ (256,329)        | \$ (14,297)       |
| Foreign currency net translation (loss) gain  | (13,247)            | 6,634             |
| Pension benefit obligation                    | (472)               | -                 |
| <b>Total other comprehensive loss</b>         | <b>\$ (270,048)</b> | <b>\$ (7,663)</b> |

| <i>(in thousands of dollars)</i>                           | <b>2008</b>         | <b>2007</b>       |
|--|---------------------|-------------------|
| Accumulated other comprehensive (loss) income consists of  |                     |                   |
| Net unrealized (losses) gains on securities                | \$ (131,973)        | \$ 124,357        |
| Foreign currency translation (loss) gain                   | (250)               | 12,997            |
| Pension benefit obligation                                 | (724)               | (252)             |
| <b>Total accumulated other comprehensive (loss) income</b> | <b>\$ (132,947)</b> | <b>\$ 137,102</b> |

# Workers' Compensation Reinsurance Association

## Notes to Financial Statements

### December 31, 2008 and 2007

Gross gains of \$197.0 million and \$168.9 million, and gross losses of \$259.1 million and \$96.0 million, were realized on sales of investments during 2008 and 2007, respectively. Additional realized losses of \$86.1 million and \$10.7 million were recognized due to other than temporary impairment of securities during 2008 and 2007, respectively. Net investment income and net realized investment (losses) gains during the years ended December 31, 2008 and 2007, are summarized below:

| <i>(in thousands of dollars)</i>       | Net Investment<br>Income |                  | Net Realized<br>(Losses) Gains |                  |
|--|--------------------------|------------------|--------------------------------|------------------|
|  | 2008                     | 2007             | 2008                           | 2007             |
| Cash and cash equivalents              | \$ 1,471                 | \$ 2,441         | \$ 8,702                       | \$ 3,657         |
| Common and preferred<br>stocks         | 13,315                   | 12,565           | (102,166)                      | 61,533           |
| Bonds                                  | 25,790                   | 26,623           | (45,951)                       | (2,579)          |
| Securities lending                     | 6,276                    | 13,184           | (8,784)                        | (442)            |
| Miscellaneous                          | 150                      | 286              | -                              | -                |
|  | <b>47,002</b>            | <b>55,099</b>    | <b>\$ (148,199)</b>            | <b>\$ 62,169</b> |
| Investment expenses                    | (5,262)                  | (5,645)          |                                |                  |
| Securities lending interest<br>expense | (5,335)                  | (12,478)         |                                |                  |
| Securities lending bank fees           | (176)                    | (157)            |                                |                  |
|  | <b>\$ 36,229</b>         | <b>\$ 36,819</b> |                                |                  |

In 2008, net realized losses consisted of losses on securities of approximately \$157 million and foreign currency translation gain of \$9 million. In 2007, net realized gains consisted of gains on securities of approximately \$58 million and foreign currency translation gain of \$4 million.

The Association participates in a securities lending program. At December 31, 2008, the Association had equity and fixed income securities with fair values of approximately \$75 million on loan. At December 31, 2007, the Association had equity and fixed income securities with fair values of approximately \$258 million on loan.

The Association reflects the collateral received for securities on loan on the balance sheet if the Association has control over the collateral. An asset of approximately \$64 million and \$263 million, and the related liability representing the collateral received of \$76 million and \$264 million, are reflected on the balance sheet at December 31, 2008 and 2007, respectively. The Association made a determination that a decline in the fair value of certain collateral investments was other than temporary, and a write down of approximately \$8.8 million in 2008 and \$.4 million in 2007 was recorded in earnings as realized losses. In addition, an unrealized loss of \$2.2 million in 2008 and \$.8 million in 2007 was recorded to reflect a decline in fair value of collateral investments believed to be temporary. See also Note 9, Contingencies

**Workers' Compensation Reinsurance Association**  
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**4. Liabilities for Losses and Loss Expenses**

The liability for losses and loss expenses at December 31, 2008 and 2007, is summarized as follows:

| <i>(in thousands of dollars)</i>                      | <b>2008</b>  | <b>2007</b>  |
|---|--------------|--------------|
| Funded, undiscounted                                  | \$ 5,778,591 | \$ 5,749,270 |
| Discount  | (4,339,656)  | (4,323,049)  |
| Claims receivable from litigation settlement (Note 8) | (3,386)      | -            |
| Funded, discounted                                    | 1,435,549    | 1,426,221    |
| Unfunded, undiscounted                                | 1,449,533    | 1,736,590    |
| Discount  | (1,285,161)  | (1,553,526)  |
| Unfunded, discounted                                  | 164,372      | 183,064      |
| Total, discounted                                     | \$ 1,599,921 | \$ 1,609,285 |

**Funded Liabilities**

Activity in the funded liability for losses and loss expenses is summarized as follows:

| <i>(in thousands of dollars)</i>                      | <b>2008</b>  | <b>2007</b>  |
|---|--------------|--------------|
| Balance at January 1                                  |              |              |
| Funded, undiscounted                                  | \$ 5,749,270 | \$ 4,977,105 |
| Incurring related to                                  |              |              |
| Current year  | 404,077      | 360,357      |
| Prior years   | (313,786)    | 476,714      |
| Total incurred  | 90,291       | 837,071      |
| Paid related to                                       |              |              |
| Current year  | 187          | 41           |
| Prior years   | 60,783       | 64,865       |
| Total paid  | 60,970       | 64,906       |
| Balance at December 31                                |              |              |
| Funded, undiscounted                                  | 5,778,591    | 5,749,270    |
| Discount  | (4,339,656)  | (4,323,049)  |
| Claims receivable from litigation settlement (Note 8) | (3,386)      | -            |
| Funded, discounted                                    | \$ 1,435,549 | \$ 1,426,221 |

Reserves are reviewed periodically and updated based on current claims experience, trends, and economic outlook.

The following table compares the present value of the Association's funded reserve changes during 2008 with those of 2007.

|                           | <b>2008</b> | <b>2007</b> |
|---------------------------|-------------|-------------|
| Discount rate at year end | 7.0%        | 7.0%        |

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| <i>(in thousands of dollars)</i>                      | <b>2008</b>  | <b>2007</b>  |
|---|--------------|--------------|
| Funded reserves as of prior year end                  | \$ 1,426,221 | \$ 1,342,320 |
| Prior year impact of actuarial adjustments            | (100,357)    | (4,145)      |
| Payments on prior accident years                      | (60,783)     | (64,865)     |
| Present value update                                  | 97,708       | 91,692       |
| Reserves for current accident year                    | 76,146       | 61,219       |
| Total calendar year funded reserve changes            | 12,714       | 83,901       |
| Claims receivable from litigation settlement (Note 8) | (3,386)      | -            |
| Funded reserves as of year end                        | \$ 1,435,549 | \$ 1,426,221 |

At year-end 2008, the significant reduction in prior year loss reserves was due primarily to favorable development on case-incurred losses. This favorable case development resulted in lower projected ultimate losses for all three retention levels.

**Unfunded Liabilities**

Payments on prior accident years in excess of prefunded limits totaled \$1,225,000 and \$1,074,000 in 2008 and 2007, respectively. Anticipated payments in excess of prefunded limits are billed as premiums for the unfunded layer.

The unfunded reserve methodology follows the funded analysis. Discount rates for unfunded reserves are the same as the funded reserves. The table below compares the present value unfunded reserve changes during 2008 with those of 2007.

| <i>(in thousands of dollars)</i>             | <b>2008</b> | <b>2007</b> |
|--|-------------|-------------|
| Unfunded reserves as of prior year end       | \$ 183,064  | \$ 169,528  |
| Prior year changes                           |             |             |
| Prior year impact of actuarial adjustments   | (35,654)    | (4,048)     |
| Payments on prior accident years             | (1,225)     | (1,074)     |
| Present value update                         | 12,772      | 11,830      |
| Reserves for the current accident year       | 5,415       | 6,828       |
| Total calendar year unfunded reserve changes | (18,692)    | 13,536      |
| Unfunded reserves as of year end             | \$ 164,372  | \$ 183,064  |

At year-end 2008, favorable development on case-incurred losses resulted in a reduction in the unfunded liabilities. This favorable case development resulted in lower projected ultimate losses.

Reserve changes for the unfunded layer do not have an impact on accumulated surplus because on the statement of operations, unfunded losses incurred (which include reserve changes) are offset by an unfunded deferred premium.

# Workers' Compensation Reinsurance Association

## Notes to Financial Statements

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#### 5. Employee Benefit Plans

##### Defined Benefit Pension Plan

The Association has a non-contributory defined benefit pension plan that covers employees who meet eligibility and entry date requirements. The Association uses a December 31 measurement date. The plan's current investment mix includes 55% equities and 45% debt securities. The determination of the long-term rate of return on plan assets was based on historical rates of return and future estimated returns for the individual assets classes. Based on the target allocation, the overall expected long-term rate of return for the plan is 8%.

Benefits paid in 2008 were \$111,109. The estimated benefit payments for 2009 are \$418,249.

| <i>(in thousands of dollars)</i>  | 2008     | 2007     |
|---|----------|----------|
| Benefit obligation, end of year   | \$ 1,982 | \$ 1,978 |
| Plan assets at fair value, end of year  | 1,258    | 1,726    |
| Funded status (recognized as a component of accrued liabilities and accumulated comprehensive income) | \$ (724) | \$ (252) |
| <i>(in thousands of dollars)</i>  | 2008     | 2007     |
| Employer contributions  | \$ 135   | \$ 130   |
| Discount rate   | 6.70%    | 6.47%    |
| Expected return on plan assets  | 8.00%    | 8.00%    |
| Rate of compensation increase   | 4.00%    | 4.00%    |

Effective December 31, 2007, the Association adopted SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. This statement requires recognition of the overfunded or underfunded status of defined benefit plans as an asset or liability in the balance sheet and to recognize the changes in that funded status in comprehensive income in the year the changes occur.

##### Defined Contribution Plan

The Association sponsors a defined contribution plan, which covers employees who meet the plan's eligibility requirements and have completed the service requirements, under Section 401(k) of the Internal Revenue Code. Participants can contribute a certain percentage of their compensation (subject to annual contribution limits) to the plan. The Association will match a maximum of 6% of participant eligible compensation. The Association's matching contribution to the plan was \$103,112 and \$94,726 in 2008 and 2007, respectively.

#### 6. Income Tax Status

In 1996, the Association was granted an exemption from federal income taxes under Section 501(c)(27)(a) of the Internal Revenue Code. The Association received a tax-exempt determination letter from the Internal Revenue Service dated February 7, 1997. Therefore, no provision for income taxes is included in the Association's financial statements.

#### 7. Fair Value Measurements

SFAS No. 157 defines fair value as the exit price that would be received for an asset in the principal or most advantageous market for the asset. See Note 2 for the three levels of inputs that may be used in measuring fair value. The fair value of the \$642.5 million of the investment securities was determined using Level 1 inputs consisting of quoted prices for identical securities in active

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markets. The fair value of the \$418.9 million of the investment securities was determined using Level 2 inputs consisting of quoted prices for similar securities in active markets. There were no securities where the fair value was determined using Level 3 inputs, i.e. unobservable inputs supported by little or no market activity.

Assets measured at fair value are summarized below:

| <i>(in thousands of dollars)</i>   | Fair Value Measurement Using |                   |             |           | Total<br>Fair Value |
|--|------------------------------|-------------------|-------------|-----------|---------------------|
|  | Level 1                      | Level 2           | Level 3     |           |                     |
| <b>As of December 31, 2008</b>   |                              |                   |             |           |                     |
| Short-term   | \$ -                         | \$ 3,401          | \$ -        | \$        | 3,401               |
| Securities lending collateral  | -                            | 63,717            | -           |           | 63,717              |
| Common stocks  | \$ 567,029                   | \$ -              | \$ -        | \$        | 567,029             |
| Preferred stocks   | -                            | 6,786             | -           |           | 6,786               |
| <b>Total stocks</b>  | <b>\$ 567,029</b>            | <b>\$ 6,786</b>   | <b>\$ -</b> | <b>\$</b> | <b>573,815</b>      |
| U.S. Treasury securities<br>and obligations of U.S.<br>government and agencies | \$ 75,463                    | \$ 7,098          | \$ -        | \$        | 82,561              |
| Corporate debt securities  | -                            | 193,000           | -           |           | 193,000             |
| Mortgage-backed securities   | -                            | 144,880           | -           |           | 144,880             |
| <b>Total bonds</b>   | <b>\$ 75,463</b>             | <b>\$ 344,978</b> | <b>\$ -</b> | <b>\$</b> | <b>420,441</b>      |

**8. Cash Flows and Liquidity**

A reconciliation of net loss to net cash provided by operating activities for the years ended December 31, 2008 and 2007, is as follows:

| <i>(in thousands of dollars)</i>   | 2008             | 2007             |
|--|------------------|------------------|
| Net loss   | \$ (120,270)     | \$ (9,430)       |
| Adjustments to reconcile net loss to net cash provided by operating activities                     |                  |                  |
| Net realized investment losses (gains)   | 148,199          | (62,169)         |
| Increase in claims receivable from litigation settlement   | (3,386)          | -                |
| Decrease (increase) in funded uncollected reinsurance premiums, net of accrued premium adjustments | 586              | (491)            |
| Increase in liability for funded losses and loss expenses  | 9,328            | 83,901           |
| Other, net   | 1,816            | 215              |
| <b>Total adjustments</b>   | <b>156,543</b>   | <b>21,456</b>    |
| <b>Net cash provided by operating activities</b>   | <b>\$ 36,273</b> | <b>\$ 12,026</b> |

# **Workers' Compensation Reinsurance Association**

## **Notes to Financial Statements**

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As a result of overall investment market conditions, the Association incurred significant investment losses in 2008. These investment losses resulted in a significant increase in the comprehensive loss and the accumulated deficit. However, the Association has substantial liquidity and the net cash provided by operating activities increased in 2008. In addition, the Association has a marketable investment portfolio that can provide significant liquidity. During 2008, the Association met all of its financial obligations on a timely basis and has the liquidity necessary to continue to do so for the foreseeable future.

#### **9. Contingencies**

During 2008, the Association reached a \$20 million settlement of a lawsuit against American International Group ("AIG") charging that AIG had understated its workers' compensation premiums in Minnesota since 1985. The settlement compensated the Association for unpaid reinsurance premiums and lost investment income. The Association received \$16.5 million in cash and recorded a \$3.5 million receivable for offsets against future claims payable to AIG.

In October 2008, the Association, along with three other Minnesota nonprofit organizations, filed a lawsuit against Wells Fargo Bank, N.A., in Minnesota District Court in Ramsey County. The lawsuit relates to the Wells Fargo securities lending program and charges that Wells Fargo breached contracts, breached fiduciary responsibilities, and engaged in misrepresentations in connection with the program. The lawsuit seeks to recover significant losses incurred by the Association from participation in the Wells Fargo securities lending program. The trial has been scheduled for January 11, 2010.

# **WCRA<sup>®</sup>**

## **Workers' Compensation Reinsurance Association<sup>®</sup>**

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