EMPLOYEES EMPLOYERS SELF-INSURERS INSURERS PUBLIC

WCRA

Workers' Compensation Reinsurance Association

1998 Annual Report

To Our Members:

The WCRA Board of Directors and management established four operational goals for 1998. The progress made in accomplishing those goals enhanced the ability of the association to serve its members better by improving the financial protection it offers, its claims administration, and the information services it provides.

Goal 1 was to complete the excess funds distribution approved by the Board in early 1997. Litigation challenging the methodology used by the Board to distribute $471 million in excess funds was successfully completed on February 9, 1998. A United States District Court judge determined that the WCRA had followed state law properly in apportioning those excess funds between excess premium distributions to the association's members and excess surplus distributions to Minnesota's workers' compensation policyholders.

By the end of the year, all WCRA members but one had received their excess premium checks. More than 96,000 checks totaling $34.7 million were distributed to Minnesota employers. We appreciate the excellent cooperation provided by our members in furnishing the data necessary to issue those excess surplus checks. We also wish to acknowledge the extraordinary efforts made by our staff to complete this complex and time-consuming project.

Goal 2 focused on completing a series of internal improvements to our claims and rehabilitation services. The claims information system was enhanced in a number of important ways. An automated reimbursement function that eliminates manual calculations and duplication of data input has reduced both the number of errors and the processing time for reimbursements. The claims and information staffs developed a computerized claims settlement tool to evaluate and respond more efficiently to proposed member settlements. The claims review process was streamlined by eliminating a number of redundant tasks and

Jay Benanav, Michael Markman

providing members with more up-to-date information. Finally, improvements to the information systems were implemented to enhance internal communications among claims and rehabilitation staff members, thus enabling them to provide better service to members. These changes contributed to reductions in the turnaround time on initial reports from 2.5 days in 1997 to 1.4 days in 1998 and in reimbursement processing time from an average of 2.1 days in 1997 to 1.3 days in 1998. Factoring in the reduction in the size of the claims staff over the last several years and the increased number of reimbursements processed, productivity increased by 90 percent over the last three years.

Goal 3 emphasized maintaining positive and effective legislative and regulatory relationships. As a quasi-public organization, the scope of the WCRA's activities is established by statute, and many of its activities are regulated by the Minnesota Commissioner of Labor and Industry. While no legislation affecting the WCRA was enacted during the year, the WCRA did respond to a number of questions about the association and its operations from individual legislators and their staffs. Commissioner of Labor and Industry Gretchen Maglich, who was recently reappointed to her position by newly elected Governor Jesse

Ventura, discharged her most important WCRA regulatory oversight function by thoroughly reviewing and approving the WCRA's 1999 rates. She reappointed Bernard Brommer, Laurence Koll, and Mary Paidosh to the WCRA Board of Directors, approved a number of amendments to the Plan of Operation, and ratified a new 1999 reinsurance agreement form for the association. We look forward to maintaining a professional and businesslike relationship with the commissioner and her department.

Goal 4 included a number of administrative changes designed to improve the operational effectiveness of the association. An integral component of maintaining the association's financial stability is the management of its investment portfolio. During the year, two international equity managers were retained to enable the WCRA portfolio to reflect the increasing globalization of the economy. A small-cap value manager was added, and management of the fixed income portfolio was consolidated in the two managers who have delivered the most consistently successful performance. Even though 1998 was an extremely volatile year in the markets, the total portfolio earned a 15.19 percent rate of return, which compares favorably with the association's long-term targeted return assumption of 8 percent.

A business recovery plan was developed to enable the association to continue providing service to our members in the event of a disaster. Specifications for a new premium audit management and reporting process were completed. A Year 2000 project plan was developed to ensure that no disruption of service to our members will occur as a result of the upcoming millenium change. Substantial progress has been made in testing our internal information systems, and verification of the Year 2000 compliance status of the WCRA's business partners is near completion.

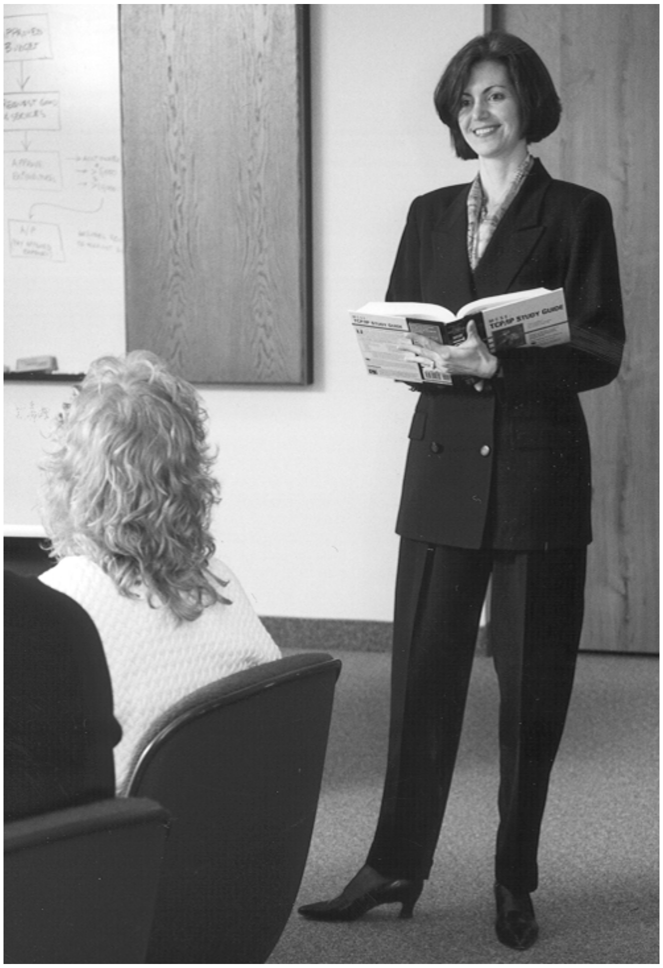
These operational effectiveness improvements are expected to have a positive impact on the association's administration over the long term. For the year, the ongoing operational improvement of the organization is reflected in the association's 1998 operating expenses of $2.9 million, which was 7.8 percent under budget and is largely unchanged since 1990.

We want to acknowledge the retirement of Wayne Simoneau from the Board of Directors. Mr. Simoneau has served on the Board in his capacity as Minnesota Commissioner of Finance. He was previously a member of the Minnesota House of Representatives, where he sponsored the legislation creating the WCRA in 1979. His long-standing support for and service to the WCRA have contributed greatly to the success of the association.

In 1998, the association continued to strengthen its financial condition and improved its ability to meet the reinsurance needs of its members. As a result, we have a solid base that will allow us to continue to provide excellent service to our members in 1999 and into the new millenium.

Michael D. Markman
Chair of the Board

Jay Y. Benanav
President and Chief Executive Officer



Finance Department

Mary C. Johnson, CPA, is the senior vice president and treasurer of the WCRA. In this role, she leads the investment and accounting functions of the association. She oversees management of the association's $1.2 billion investment portfolio and works with the Board of Directors, committees, senior management, and staff to address financial and operational issues and projects.

Financial issues and projects that commanded the staff's time and efforts during 1998 included implementing a revised asset allocation policy for the investment portfolio and managing and distributing excess funds declared by the Board in 1997.

In late 1997, the Board authorized investment in foreign equity securities and also authorized allocation refinements within the domestic equity segment of the investment portfolio. Based upon these directives, the first half of 1998 was spent implementing the new target allocation. The fixed income portfolio, which was reduced from 50 percent to 40 percent of the total WCRA portfolio, was restructured to be managed by two of the existing five managers at the time. Two managers were hired in January to implement the 10 percent allocation to international equity portfolios. Additionally, a small-cap value equity manager was hired in April 1998 to achieve the targeted allocation of 70 percent large- and 30 percent small-cap equities within the domestic equity portfolio, thus providing a balance between growth and value styles of investment management. The Board's directive was accomplished successfully; and, while not directly driving performance for the year, the new allocation did contribute to achieving returns in excess of the long-term targeted rate of 8 percent.

In February 1998, a United States District Court decision resolved the outstanding issues related to the distribution of excess funds that had been declared by the Board. The WCRA completed distribution of funds to its insurer members and began the process of distributing $36 million to approximately 100,000 employers in Minnesota. This process was held open until February 9, 1999, one year following the court decision, and is currently in a wind-down stage, with closure planned for fourth quarter of 1999.

Actuarial and Premium Departments

The actuarial and premium departments are managed by **Jane Jasper Krumrie**, vice president and actuary.

New and current WCRA members provide information that the premium staff uses to determine coverage levels, exposure levels, premium rates, and member contacts. The staff calculates member premiums, bills members, maintains premium cash collections, answers coverage and billing questions, and regularly conducts premium data audits to maintain the integrity of the WCRA premium data.

The actuarial department calculates the rates and retention limits of the WCRA and determines the level of reserves necessary for the association to meet its obligations for serious workers' compensation claims. Rate indications are quantified annually by projecting costs for the upcoming year and dividing this number by the estimated WCRA exposure for that year. Retention limits are set according to legislative statute.

The year-end 1998 reserve analysis increased WCRA liabilities by $24.4 million. However, since the association's corresponding assets increased by $39.3 million during 1998, the net impact on surplus is an increase of $14.9 million. Because this surplus increase arises from the "actuarial impact" portion of the reserve change, it is also an increase in the excess premium of the WCRA. Since year end 1992, when the association had a surplus of zero, the WCRA's actuarial reserve reductions have totaled $385.3 million, of which $284.7 million has been distributed to members as excess premium and premium credits. The difference of $100.6 million is excess premium that remains as part of the association's surplus as of year end 1998.

The ratemaking process was completed in September with the Board's adoption of the 1999 WCRA rates. The rates were finalized with the approval of the Commissioner of Labor and Industry. The association's rates have remained quite stable. The 1999 rates of 6.8 percent and 3.2 percent are unchanged from 1998 for the low and high retention. The super retention increased from 1.5 to 1.6 percent.

Claims and Information Systems Departments

The primary product the WCRA delivers to its members is claims reimbursements. **Elisabeth M. Skoglund**, vice president of claims, manages this vital function for the association.

One goal of the claims department is to balance the needs of members, injured workers, and employers while protecting the association's financial integrity. The WCRA staff provides expert claims and rehabilitation advice in catastrophic injuries and assists members in areas such as reserving practices and settlement evaluation. Once a claim exceeds the retention limit, the staff helps members file reimbursement requests and provides prompt and accurate payment.

During 1998, the claims department enhanced its computer system, which allows for more streamlined procedures. This, in turn, resulted in improved quality and timeliness. For example, the reimbursement processing turnaround time decreased from 2.1 days in 1997 to 1.3 in 1998. The number of reimbursement requests showed a small increase for the year; however, the dollar amount paid on reimbursement claims in 1998 was slightly lower than projected. The number of initial reports continued to decline but at a slower rate than anticipated. The claims department has continued emphasizing the importance of customer service. Many positive comments on customer survey cards confirm that the claims and rehabilitation staff has developed a good partnership with the members.

During 1998, the vice president of claims was given responsibility for managing the WCRA's information system department (IS), which maintains the association's hardware and software and provides technical assistance to employees. In addition, IS ensures proper security and protection of WCRA electronic data bases. In 1998, IS implemented technology that keeps the WCRA up to date, efficient, and compatible with outside organizations. The WCRA's e-mail system was upgraded, and the memory and processors of all older computer systems were replaced. A new electronic backup system was also deployed. Finally, IS was active in ensuring Year 2000 compliance, and most of the necessary testing was completed.

Legal Department

Responsibility for legal, legislative, and regulatory affairs rests with the association's general counsel, **Carl W. Cummins**. He serves as the WCRA's secretary and is responsible for publications and external affairs. In addition, the vice president - claims and assistant vice president - rehabilitation report to the general counsel.

The scope of the general counsel's legal responsibilities includes a wide variety of general duties ranging from advising the Board of Directors on legal issues to drafting contracts to ensuring that the association complies with state and federal laws. The more specialized needs of the association require him to resolve claims issues concerning the interpretation of Minnesota's workers' compensation laws, draft the association's reinsurance agreements and amendments to its Plan of Operation and operating rules, and resolve any disputes involving the association's relationship with its members. During 1998, he worked with outside counsel to bring the litigation involving the WCRA's 1997 surplus distribution to a successful conclusion. He subsequently ensured that the association's staff complied with the necessary legal requirements in distributing nearly $36 million in excess surplus funds to Minnesota workers' compensation policyholders.

As a quasi-public agency created by the Minnesota Legislature and regulated by the Commissioner of Labor and Industry, the WCRA has an ongoing interest in legislative and regulatory issues. The general counsel monitors legislative activities that might affect the workers' compensation system, provides information to the Minnesota Legislature about the WCRA and its responsibilities, and coordinates the provision of information about serious workers' compensation claims to public policymakers. He is responsible for securing regulatory approvals of the association's annual reinsurance rate filings, appointments by the Commissioner of Labor and Industry to the WCRA Board of Directors, approvals of surplus distributions, and ratification by the Commissioner of any proposed amendments to the WCRA Plan of Operation.

Administration

While she carries the title of director of human resources (HR), **Cynthia M. Smith** is also the officer responsible for the WCRA's general operations. She performs the traditional HR functions from compensation to training, is responsible for the corporate insurance program, and oversees all aspects of the association's day-to-day operations.

In 1998, three general operations projects received emphasis: enhancing employee skills to better serve our members; developing a business recovery plan to be implemented in the event of a disaster or other business interruption; and ensuring that the association is Year 2000 compliant.

The WCRA's long-established philosophy has been to provide ongoing training and development to enhance its employees' knowledge and skills. In 1998, management worked with staff to identify professional growth needs and helped them fulfill these needs. Through the ongoing upgrading of skills and the use of automation, the WCRA is able to maintain stable staffing levels and improve service to our

Also during 1998, staff completed a business recovery plan addressing emergency situations that may arise during the course of business. All departments worked together to identify critical functions, procedures, and recovery partners that would enable rapid recovery from an occurrence that would disable the association.

The WCRA has been working on Year 2000 issues to ensure that no disruption of service to our members will occur as a result of the upcoming century change. The WCRA Year 2000 project plan is a top priority of the association. A team consisting of representatives from various departments within the association has identified networks, systems, and software that might be affected. Solutions designed to prevent problems are being implemented, and testing will continue through 1999. All significant business partners have been contacted to assess their Year 2000 readiness, and contingency plans are being developed in the event that the system of any business partner or vendor is not compliant.

Management's Summary Analysis Of 1998 Financial Results

Over the last several years, the WCRA has been able to report excellent financial results, and 1998 was no exception. A strong performance by the investment portfolio was the major contributor to the WCRA's reported surplus of $349 million.

Investment Portfolio

Total investments grew to $1,332.1 million at December 31, 1998, from $1,015.8 million the prior year. Portfolio contributions are summarized below.

Contributions of Investment Portfolio (in millions)

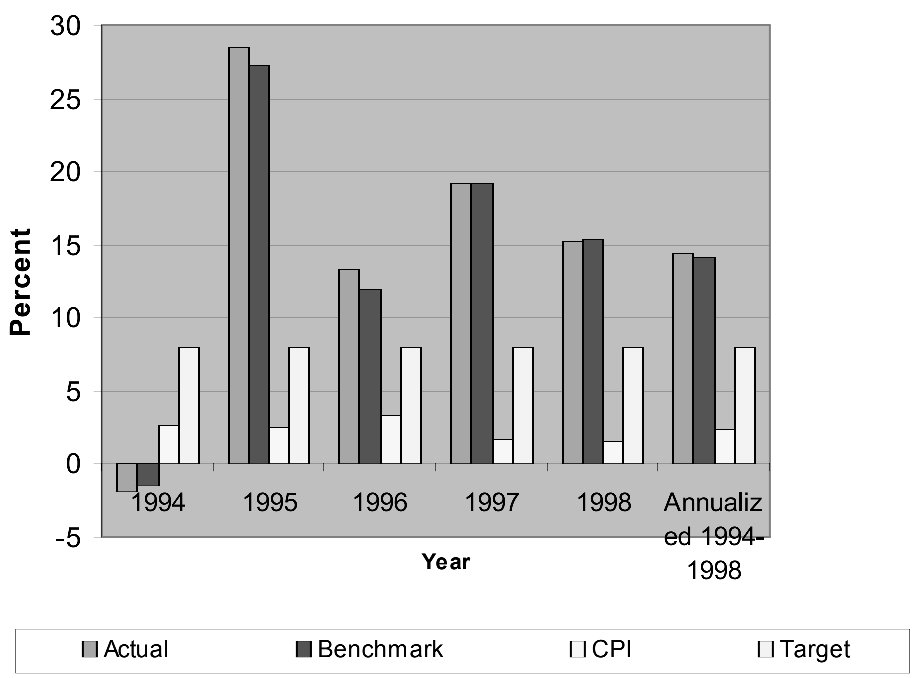
	1998	1997
Investment income	$ 36.4	$ 41.9
Realized gains	134.8	117.4
Change in unrealized market value during the year	(17.9)	12.7
Total contribution	$ 153.3	$ 172.0
Total return for year	15.19 %	19.24 %

While the association experienced the volatility of the markets (as did most organizations during 1998), the portfolio posted a 15.19 percent return for the year, which compares favorably to the long term target rate of 8 percent. Comparative returns for the last five years are summarized in the chart at the bottom of this page.

Liabilities for Funded Losses

Liabilities of $811.6 million for funded losses and loss adjustment expenses were reported at December 31, 1998. This is an increase of $24.4 million compared to year end 1997. Since the association's asset changes that correspond to the reserve changes were $39.3 million over the same time period, the actuarial impact from this year's reserve analysis was a surplus increase of $14.9 million. The table on the following page displays this figure.

Incurred claims include all open claims plus those that have been closed with payment. During 1998, the number of WCRA-incurred claims continued to decrease, a trend first observed in 1995. However, the rate of decline has slowed dramatically. Claim counts decreased by 0.2 percent in 1998, compared to decreases of 2 to 3 percent over the 1995-1997 period. In spite of the



fact that the incurred count decline has slowed, the recognition of lower-than-expected claim frequency is, by far, the largest contributor to the year-end 1998 actuarial reserve reduction of $14.9 million.

Compared to the 1995-1997 reviews, very few procedural enhancements were implemented in the 1998 actuarial analysis. For additional information about the actuarial analysis of losses, refer to footnote 2 to the audited financial statements.

Incurred funded losses and loss adjustment expenses are summarized in the following table.

WCRA Funded Losses and LAE Incurred (in millions)

	1998	1997
On prior accident years:		
Present value update	$ 45.7	$ 66.8
Payments made during calendar year	33.6	35.3
Reduction of reserves for payments made	(33.6)	(35.3)
"Actuarial Impact" portion of the reserve change	(14.9)	(43.8)
	30.8	23.0
On the current accident year:	27.3	25.1
Total funded losses and LAE incurred	$ 58.1	$ 48.1

Reporting Changes Implemented in 1998

During 1998, the WCRA implemented two new accounting statements. Financial Accounting Standards Board (FASB) Statement Number 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," requires that any securities lending programs be reflected on the financial statements of the organization. The WCRA does participate in such a program and has reflected the collateral for securities on loan as part of the cash and cash equivalent portion of the investment portfolio, offset by a payable under the agreement. FASB No. 130, "Reporting Comprehensive Income," requires that certain components of financial results, previously disclosed as direct changes to equity, be included in the calculation of other comprehensive income in addition to operating income of the organization. For the WCRA, this amounted to reporting the change in unrealized market value of investment securities as part of total income rather than a change in surplus. Additionally, surplus reported on the balance sheet is analyzed based upon its sources. For the WCRA, sources are operations and unrealized changes in market value on the investment portfolio.

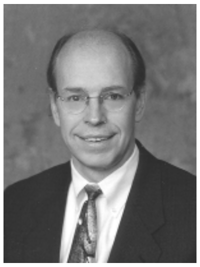
The implementation of these two accounting statements only affects the presentation of the financial statements. The actual financial results of the association are not affected by the adoption of the statements.

Evaluating Financial Position

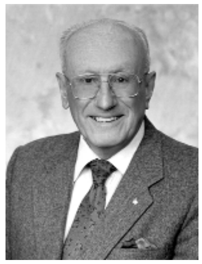
When the Board evaluates the financial position of the WCRA, it weighs the reported surplus or deficit against the liabilities of the association, evaluating not only the inherent risks in the liabilities but also in the investment portfolio. The Board's framework for this evaluation is established in The Operating Rule For The Determination Of Surplus and includes not only consideration of the financial risks of the business but consideration of subsequent events (for example, changes in the market valuation of investments). The Board formalized this framework in 1993 and examines the operating rule periodically to ensure that it accurately reflects the business environment in which the WCRA operates. In 1998, the Board decided to report the designated surplus defined in the rule on the face of the financial statements, with a full description in footnote 2 of the financial statements. The goal of this disclosure is to assist the reader in realistically evaluating the WCRA's financial position.

WCRA Board of Directors

Insurer Representatives

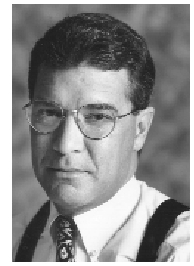


Michael Markman
Zurich - US



George Klouda
Western National

Tom Driscoll
Liberty Mutual



Stephen Lilienthal
The St. Paul Companies

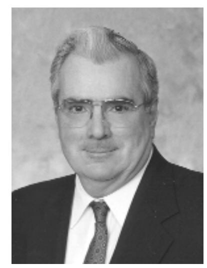
Self-insurer Representatives

Gary Swoverland
Land O'Lakes

Susan Herboldt
Itasca County

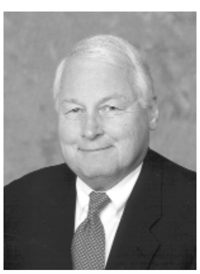
Employee Representatives

Bernard Brommer
AFL-CIO



Donald Gerdesmeier
Minnesota D.R.I.V.E.

Employer Representatives



Laurence Koll
Koll, Morrison & Charpentier

Bradley Robinson
Robinson Rubber Co.

Public Representative

Mary Paidosh
Franklin National Bank

State Officials

Howard Bicker
State Board of Investment

Pam Wheelock
Commission of Finance

Report of Independent Accountants

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

In our opinion, the accompanying balance sheets and the related statements of operations, comprehensive income and surplus and cash flows present fairly, in all material respects, the financial position of the Workers' Compensation Reinsurance Association at December 31, 1998 and 1997, in conformity with generally accepted accounting principles. 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 generally accepted auditing standards 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 the opinion expressed above.

As discussed in Note 2 and Note 6, the Association adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" and Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" as of December 31, 1998.

PricewaterhouseCoopers LLP

February 9, 1999

WORKERS' COMPENSATION REINSURANCE ASSOCIATION

Balance Sheets

as of December 31, 1998 and 1997 (in thousands)

ASSETS	**1998**	**1997**
Investments, at market value:		
Cash and cash equivalents	$ 209,296	$ 123,298
Common and preferred stock	693,573	530,488
Bonds	429,244	361,978
Total investments	1,332,113	1,015,764
Restricted cash and cash equivalents	8,860	119,053
Uncollected reinsurance premiums:		
Due for funded losses	(122)	422
Deferred for catastrophic losses	63,766	65,987
Total uncollected reinsurance premiums	63,644	66,409
Accrued investment income	5,361	5,063
Due from securities brokers	14,218	1,090
Accounts receivable and prepaid expenses	107	100
Property and equipment, less accumulated depreciation of $681 and $822 at December 31, 1998 and 1997, respectively	251	219
Total assets	$1,424,554	$1,207,698
LIABILITIES AND SURPLUS		
Liabilities:		
Losses and loss adjustment expenses:		
Funded	$ 811,573	$ 787,169
Catastrophic	63,766	65,987
Total losses and loss adjustment expenses	875,339	853,156
Payable under securities loan agreement	157,569	
Due to securities brokers	36,866	10,971
Excess funds distribution payable	5,461	116,128
Accounts payable and accrued expenses	306	347
Total liabilities	1,075,541	980,602
Contingencies		
Surplus from operations	146,097	6,268
Accumulated other comprehensive income	202,916	220,828
Total surplus, including designated surplus of $259,700 in 1998 (Note 2)	349,013	227,096
Total liabilities and surplus	$1,424,554	$1,207,698

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

Workers' Compensation Reinsurance Association

Statements of Operations, Comprehensive Income and Surplus

for the years ended December 31, 1998 and 1997 (in thousands)

	1998	1997
Revenues:		
Reinsurance premiums:		
Funded	$ 28,620	$ 27,801
Catastrophic	(2,221)	1,949
Premiums earned	26,399	29,750
Investment income, net of related expenses	36,350	41,852
Net realized investment gains	134,840	117,421
Total revenues	197,589	189,023
Expenses:		
Losses and loss adjustment expenses:		
Funded	58,063	48,114
Catastrophic	(2,221)	1,949
Losses and loss adjustment expenses incurred	55,842	50,063
Operating and administrative expenses	1,918	2,009
Total expenses	57,760	52,072
Net income	139,829	136,951
Other comprehensive income:		
Change in unrealized (losses) gains on securities	(17,912)	12,706
Comprehensive income	121,917	149,657
Surplus, beginning of year	227,096	77,439
Surplus, end of year	$ 349,013	$ 227,096

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

Workers' Compensation Reinsurance Association

Statements of Cash Flows

for the years ended December 31, 1998 and 1997 (in thousands)

	1998	1997
Cash flows from operating activities:		
Funded premiums collected	$ 29,165	$ 15,148
Interest and dividends received, net of related expenses	36,052	45,339
Loss and loss adjustment expenses paid	(33,658)	(35,329)
Operating and administrative expenses paid	(1,772)	(1,870)
Net cash provided by operating activities	29,787	23,288
Cash flows from investing activities:		
Sale of investments:		
Common and preferred stocks	543,116	450,157
Bonds	633,654	888,975
Purchase of investments:		
Common and preferred stocks	(576,593)	(206,048)
Bonds	(700,920)	(641,790)
Collateral for securities on loan	157,569	
Restricted cash and cash equivalents	110,193	(119,053)
Purchase of equipment	(141)	(78)
Net cash provided by investing activities	166,878	372,163
Cash flows from financing activities:		
Payments on excess funds distribution payable	(110,667)	(355,232)
Net cash used in financing activities	(110,667)	(355,232)
Change in cash and cash equivalents	85,998	40,219
Cash and cash equivalents, beginning of year	123,298	83,079
Cash and cash equivalents, end of year	$ 209,296	$ 123,298

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

1. General Information:

Description of Association:

In 1979, the Minnesota Legislature created the Workers' Compensation Reinsurance Association (the Association), a tax-exempt 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 under Minnesota Statutes Chapter 176 in excess of a members' retention limit.

Operating rules and procedures are prescribed by the Enabling Act, as amended, and the Plan of Operation. Amendments to the Plan of Operation 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 authorized to self-insure their workers' compensation liabilities in Minnesota are required to be members of the Association.

Retention Limit:

For 1998, members selected one of three maximum per loss occurrence retention limits which were $280,000, $560,000 or $1,120,000. For 1997, members selected one of three maximum per loss occurrence retention limits which were $270,000, $540,000 or $1,080,000. 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, using a discount rate of eight percent, of the estimated ultimate liability for members' incurred losses up to, and including, the prefunded limit of $5.6 million per occurrence for 1998 ($5.4 million per occurrence for 1997) for funded losses reinsured by the Association;

- payments, if any, made to members on claims in excess of the prefunded limit (catastrophic losses);

- loss adjustment, operating, and administrative expenses of the Association (loss adjustment expenses incurred by members on reinsured claims are not recoverable from the Association); and

- adjustments due to excess or deficient funded premiums, if any, for prior years as determined by the Board.

Estimated reinsurance premiums for each year are billed to the individual members based on: (1) the rate for the members' selected retention limit; and (2) the members' most recent actual exposure base available at the beginning of the annual billing cycle adjusted, beginning in 1996, for a factor which represents the estimated difference between the members' most recent actual exposure base and the actuarially-projected exposure base. In the following year, reinsurance premium adjustments are calculated and billed or credited to members.

For insurer members, the exposure base is the standard 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 generally accepted accounting principles 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. The most significant area which requires the use of management's estimates relate to the determination of reserves for losses and loss adjustment expenses. Actual results could differ from those estimates.

Comprehensive Income:

During 1998, the Association adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income." The standard 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 unrealized gains and losses (other comprehensive income) on available-for-sale securities. The adoption of this statement for the Association does not impact the overall financial results, only the presentation of the components of net income.

The standard also requires the reporting of reclassification adjustments for unrealized gains or losses in the prior year that were subsequently realized during 1998. Neither the Association nor its custodian maintained this information during 1998, and as a result, this adjustment has not been displayed.

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.

Investments:

The Association has classified its investments as "available-for-sale" and carries such securities at fair market value based on quoted market prices. 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.

Restricted Cash and Cash Equivalents:

Restricted cash and cash equivalents relate to amounts restricted for payment of the excess funds distribution payable (see Note 4). Interest earnings thereon are also restricted for payment of the excess funds distribution payable and related expenses. Interest earnings on restricted cash and cash equivalents totaled $1,779,000 and $15,381,000 for the years ended December 31, 1998 and 1997, respectively. These amounts are included in the excess funds distribution payable as of December 31, 1998 and 1997.

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.

Concentration of Credit Risk:

The Association has cash and cash equivalents totaling $51,727,000 held in trust in one financial institution at December 31, 1998.

The Association also invests in corporate stocks and bonds, U.S. government securities and mortgage backed securities held in trust at this institution. The investment viability and return of funds held by this institution 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.

Determination of Surplus:

After the close of each fiscal year, or at such other times that it deems appropriate, the Board will report whether a surplus or deficit exists based in the annual audited year-end financial statements. In determining whether or not to declare an excess surplus distribution or a deficiency assessment, the Board will evaluate surplus or deficit relative to the reserves for discounted funded loss and loss adjustment expenses. This provision is intended 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 percent of reserves maintained for variations between expected and actual investment returns is calculated based upon the expected volatility (standard deviation) of the WCRA investment portfolio multiplied by two. Ten percent of reserves will be maintained for variations between expected and actual claims experience, and 22 percent of reserves will be maintained for variations between expected and actual investment returns. This amount has been reflected on the balance sheet as designated surplus as of December 31, 1998.

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 more or less frequently than every five years if the Board, in 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 Minnesota Laws, Chapter 361, as interpreted by decisions of the United States District Court in *In re Workers' Compensation Refund*, entered February 11, 1994 and affirmed by the Eight Circuit Court of Appeals on January 31, 1995; and *American Compensation Insurance Company, et al, v. David B. Gruenes, as Commissioner of the Minnesota Department of Commerce, et al*., entered February 9, 1998.

Reinsurance Premiums:

The reinsurance premiums for the calendar year coverage period for funded losses (losses up to and including the prefunded limit) consist of the billed estimated funded premiums. The reinsurance premiums for the calendar years may also include a credit or charge to equitably distribute excess or deficient premiums for previous periods including any excess or deficient premium resulting from a retroactive change in the prefunded limit.

The reinsurance premiums to be billed in future years for catastrophic losses (losses in excess of the prefunded limit) incurred during the calendar year coverage period are recognized as revenue concurrent with the related catastrophic losses and loss adjustment expenses. The reinsurance premiums for catastrophic losses will be billed to the members of the Association when payments on those catastrophic losses are made.

Losses and Loss Adjustment Expenses:

The liability for funded losses and loss adjustment expenses represents the present value, discounted at eight percent of the estimated liability for losses and loss adjustment 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 catastrophic losses and loss adjustment expenses represents the present value, discounted at eight percent of the estimated liability for losses and loss adjustment expenses of the Association for unpaid amounts in excess of the prefunded limit, as determined by actuarial projections of the Association.

The liability for losses and loss adjustment expenses at December 31, 1998 and 1997 is summarized as follows (in thousands):

	1998	**1997**
Funded, undiscounted	$ 3,128,417	$ 3,110,597
Discount	(2,316,844)	(2,323,428)
	811,573	787,169
Catastrophic, undiscounted	1,067,164	1,024,067
Discount	(1,003,398)	(958,080)
	63,766	65,987
Total	$ 875,339	$ 853,156

Activity in the funded liability for losses and loss adjustment expenses is summarized as follows (in thousands):

	1998	1997
Balance, January 1:		
Funded, undiscounted	$ 3,110,597	$ 3,303,929
Incurred related to:		
Current year	161,835	155,754
Prior years	(110,357)	(313,757)
Total incurred	51,478	(158,003)
Paid related to:		
Current year	38	36
Prior years	33,620	35,293
Total paid	33,658	35,329
Balance, December 31:		
Funded, undiscounted	3,128,417	3,110,597
Discount	(2,316,844)	(2,323,428)
	$ 811,573	$ 787,169

Reserves are reviewed periodically and updated based on current claim experience and trends. Adjustments to the estimated liability for losses and loss adjustment expenses are reflected in operating results in the year when the changes are made. These adjustments may be material to the financial statements when they occur. In 1998 and 1997, actuarial adjustments, including changes in selected ultimate loss amounts on prior accident years decreased funded discounted reserves and related losses and loss adjustment expenses by approximately $15 million and $44 million, respectively.

In 1998, the changes in selected loss and loss expense amounts are a combination of the following factors quantified below:

	December 31, 1998 Impact on Funded Undiscounted Ultimate Loss and Loss Expense (Millions)	**December 31, 1998 Impact on Funded Discounted Loss and Loss Expense Reserves (Millions)**
Downward development and annual adjustment of actuarial credibility weights	$ (118.4)	$ (25.5)
Changes in case reserving	23.4	4.2
Changes in pricing assumptions	(15.4)	6.4
1998 total	$ (110.4)	$ (14.9)

In 1997, the changes in selected loss and loss expense amounts were a combination of the following:

	December 31, 1997 Impact on Funded Undiscounted Ultimate Loss and Loss Expense (Millions)	December 31, 1997 Impact on Funded Discounted Loss and Loss Expense Reserves (Millions)
Downward development and annual adjustment of actuarial credibility weights	$ (224.8)	$ (56.4)
Continued enhancement of actuarial methodology:		
Actuarial change in group definitions:		
Loss analysis	(194.3)	(42.7)
Discount factors		31.1
Reversal of annual adjustment of actuarial credibility weights	105.4	24.2
1997 total	$ (313.7)	$ (43.8)

The year-end 1997 actuarial reserve review revealed that the downward development in claim counts, which began in 1995, continued in 1996 and 1997. During 1998, incurred claim counts increased slightly for the low retention. For the high retention, the downward trend in incurred claim counts continued through 1998, but the rate of the decline slowed dramatically. For the combined retentions, incurred claim counts decreased by 0.2 percent in 1998, compared to decreases of 2 to 3 percent over the 1995 to 1997 period. In spite of the fact that the decline in incurred claim counts has slowed down, the recognition of lower-than-expected claim frequency is, by far, the largest contributor to the year-end 1998 reserve reduction. Low and super retention counts were neutral factors. The decrease in the high retention ultimate frequency selections accounts for over 90 percent of the decrease in reserves for the year ended December 31, 1998.

Very few actuarial enhancements have been implemented for the 1998 WCRA reserve analysis. An expanded selection of life expectancy tables was implemented in May 1998 and has been appropriated for most of the Association's case reserves. For funded losses, this change in case reserves increased overall reserve levels because the majority of claims affected received longer life expectancies. The pricing assumptions used to set reserves were improved to reflect our current knowledge about the impact of social security benefits on our exposure to loss and the impact of trend on nonlifetime indemnity benefits.

3. Income Tax Status:

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

4. Excess Funds Distribution and Future Premium Reductions:

In December 1996, based on projected year-end financial results, the Board of Directors determined that there was a projected surplus of approximately $500 million, which constituted an extraordinary accumulation of surplus in excess of funds necessary to meet the Association's long-term liabilities. This surplus was attributable to a combination of reductions in funded loss and loss adjustment expense reserves and positive investment performance. As a result, the Board declared a distribution of $448.4 million, which is equal to the Association's 1996 adjusted surplus, less an amount equal to 10 percent of the funded loss and loss adjustment expense reserves, discounted at 8 percent, as calculated in accordance with the Operating Rule for the Determination of Surplus.

In 1996, the Board of Directors resolved that premiums would be adjusted by providing a premium credit to all members not to exceed the super retention rate during the period from July 1, 1996, until exhausted, which was projected to occur in 1999. In December 1996, the Board resolved that the premium reduction would be distributed only through 1997 and included the unused portion of $23 million with the distribution described in the paragraph above. Accordingly, the unused $23 million was included in the excess funds distribution payable as of December 31, 1997. The premium credit applied in 1997 was $12.5 million.

On January 30, 1997, the Board approved excess premium and excess surplus distributions of $329.1 million to member insurers, $108.3 million to member self-insurers and $34.0 million to Minnesota workers' compensation policyholders (policyholders). By law, the distributions of excess premiums are subject to approval by the Commissioner of Labor and Industry and distributions of excess surplus are subject to approval by the Commissioner of Labor and Industry and review by the Commissioner of Commerce.

On May 15, 1997, the commissioners jointly issued an Order Amending and Approving Application for Excess Surplus Distribution. This order did not recognize a distinction between excess premiums and excess surplus and treated all funds available for distribution as excess surplus. It approved the requested distribution of $471.4 million, but changed the allocations so that member insurers would receive $274.2 million, member self-insurers would receive $108.3 million and policyholders would receive $88.9 million.

In June 1997, three insurer members of the Association commenced litigation against the commissioners and the Association in the United States District Court for Minnesota challenging the constitutionality and legality under Minnesota law of the commissioners' order. These lawsuits challenged the legality of the distribution of all or a part of the $88.9 million to policyholders.

On July 31, 1997, the commissioners jointly issued an Order for Distribution of Uncontested Excess Surplus authorizing the Association to distribute $274.2 million in uncontested funds to member insurers and $108.3 million to member self-insurers. These distributions were commenced by the Association in August 1997. On February 9, 1998, a judgment was entered in United States District Court in favor of the plaintiff insurers. The commissioners did not appeal this decision and issued an order complying with the court decision approving the distributions as the Board had originally authorized them. As a result, the Association returned an additional $54.9 million to insurer members and is distributing $34.0 million in excess surplus to Policyholders.

5. Cash Flows:

A reconciliation of net income to net cash provided by operating activities for the years ended December 31, 1998 and 1997, is as follows (in thousands):

	1998	1997
Net income	$ 139,829	$ 136,951
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized investment gains	(134,840)	(117,421)
Decrease (increase) in funded uncollected reinsurance premiums, net of accrued premium adjustments	544	(186)
Increase in liability for funded losses and loss adjustment expenses	24,404	12,785
Decrease in liability for future premium reductions		(12,467)
Other, net	(150)	3,626
Total adjustments	(110,042)	(113,663)
Net cash provided by operating activities	$ 29,787	$ 23,288

6. Investments:

The cost of common and preferred stocks, amortized cost of bonds, and estimated fair values at December 31, 1998 and 1997, respectively, are as follows (in thousands):

	1998			
	Cost/ Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Common stocks	$ 489,350	$ 225,530	$ (24,759)	$ 690,121
Preferred stocks	3,660	25	(233)	3,452
Total stocks	$ 493,010	$ 225,555	$ (24,992)	$ 693,573
U.S. Treasury securities and obligations of U.S. government and agencies	$ 51,551	$ 1,467	$ (116)	$ 52,902
Corporate debt securities	215,613	3,206	(4,323)	214,496
Mortgage backed securities	159,727	2,442	(323)	161,846
Total bonds	$ 426,891	$ 7,115	$ (4,762)	$ 429,244

	1997			
	Cost/ Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Common stocks	$ 311,770	$ 216,876	$ (4,757)	$ 523,889
Preferred stocks	5,554	1,072	(27)	6,599
Total stocks	$ 317,324	$ 217,948	$ (4,784)	$ 530,488
U.S. Treasury securities and obligations of U.S.government and agencies	$ 106,998	$ 2,451	$ (11)	$ 109,438
Corporate debt securities	142,409	3,354	(370)	145,393
Mortgage backed securities	104,907	2,336	(96)	107,147
Total bonds	$ 354,314	$ 8,141	$ (477)	$ 361,978

The amortized cost and estimated fair value of debt securities at December 31, 1998, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 12,152	$ 12,340
Due after one year through five years	65,142	64,570
Due after five years through ten years	91,571	90,696
Due after ten years	258,026	261,638
Total	$ 426,891	$ 429,244

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.

Gross gains of $147 million and $149 million, and gross losses of $12 million and $31 million, were realized on sales of investments during 1998 and 1997, respectively. Net investment income and net realized investment gains (losses) during the years ended December 31, 1998 and 1997, are summarized below (in thousands):

	Net Investment Income		Net Realized Gains (Losses)	
	1998	**1997**	**1998**	**1997**
Securities lending	$ 263	$ 292		
Cash and cash equivalents	3,169	5,525	$ 2,281	$ 2,542
Common and preferred stocks	10,187	8,986	125,553	110,176
Bonds	26,687	27,289	7,006	4,703
Miscellaneous	672	2,823		
	40,978	44,915	$ 134,840	$ 117,421
Investment expenses	(4,628)	(3,063)		
	$ 36,350	$ 41,852		

To enhance the return on investments, the Association maintains a securities lending program and also invests in asset-backed, primarily government, securities. At December 31, 1998 and 1997, the Association had equity and fixed income securities with fair values of $154 million and $191 million out on loan, respectively. Cash of at least 102 percent of the fair value of the securities lent was held as collateral as part of the securities lending program.

During 1998, the Association adopted Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." The standard requires the collateral received for securities on loan to be reflected on the balance sheet if the secured party has control over the collateral. An asset of $158 million and the related liability representing the collateral received is reflected on the balance sheet as of December 31, 1998.

Additionally, to further enhance the return on investments, one of the Association's investment managers, has invested in interest rate future and interest rate option contracts. Listed contracts must be traded on a market regulated by a governmental agency, and counterparties must have a long-term debt rating of "A" or better. The interest rate future contracts are marked-to-market on a daily basis with the gain or loss reported in income. The fair value of the interest rate futures contracts held, at December 31, 1998 and 1997, were $40 million and $53 million, respectively. The fair value of the interest rate option contracts held at December 31, 1998 was $90,000. Two of the Association's investment managers have invested in currency forward contracts. The fair value of these contracts at December 31, 1998 was $6 million. There were no currency forward or interest rate option contracts held at December 31, 1997.

WCRA

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