WCRA®

Workers' Compensation
Reinsurance Association®

2001
Annual Report

TO OUR MEMBERS

The year 2001 was a year of challenges and change for the WCRA, as it was for the entire insurance industry. As a member of the association, you continue to share in the stability provided to the Minnesota workers' compensation system and financial value provided by the WCRA.


Carl Cummins, Michael Markman

The tragic events at the New York World Trade Center on September 11 challenged the entire property casualty insurance industry. An already tight market further hardened, resulting in large premium rate increases for global workers' compensation reinsurance coverage. However, since the WCRA bases its rates only on Minnesota experience, we actually reduced premium rates for 2002 by 12 percent. Further, while many reinsurers decided to exclude coverage for terroristic acts, the WCRA continues to maintain this coverage in the best interest of our members.

During the year, we mailed checks totaling $310 million to WCRA members and insured Minnesota employers, carrying out a decision reached by the Board of Directors in December 2000 to distribute surplus funds. This brings the total amount of distributed surplus funds to $1.23 billion, which compares favorably with the total of $1.01 billion premiums paid by members since 1979.

Reduced premium rates, broad reinsurance coverage, and large surplus distributions all add up to significant value for WCRA members.

Another challenge for the association was the continued poor performance of the investment markets. For the first time in seven years, our portfolio experienced a loss in value, resulting in an overall return of -4.74 percent. Nonetheless, the average annual rate of return on the portfolio since 1979 has been 12.7 percent, and the association's assets exceeded its liabilities by $86 million at year end.

The most dramatic changes at the association during 2001 occurred with the departure of two key employees and one valued Board member. Jay Benanav, who joined the WCRA in 1987 and was named president in 1989, decided that after nearly 15 years at the association, it was time to make a career change, so he left the WCRA on November 30. Following an extensive search process, the Board selected the association's general counsel, Carl "Buzz" Cummins, as the new president and chief executive officer.

Chief financial officer Mary Johnson, who had served in various capacities at the WCRA since 1985, left the association in October to accept a new position in Minneapolis. Finally, Larry Koll, a widely respected expert on the legal and public policy aspects of the Minnesota workers' compensation system, retired from the Board after 17 years of service.

All three of these individuals made enormous contributions to shaping the WCRA into the organization it is today. Each can rightfully claim a share of the credit for the association's successes. We appreciate their contributions very much, and their leadership will be missed.

Looking to the future, your Board of Directors has great confidence in the association's new leadership. Management and staff are re-energized, and we are taking a fresh look at the work of the association to ensure that you receive the best possible service and value for your premium dollar.

Michael D. Markman
Chair of the Board

Carl W. Cummins III
President and Chief Executive Officer

WCRA OVERVIEW

Introduction

The Minnesota Workers' Compensation Reinsurance Association (WCRA) was created by the Minnesota Legislature in 1979. Establishment of a state reinsurance fund was one of the recommendations of an 18-month study completed by the Minnesota Workers' Compensation Study Commission, which reached the following conclusions.

> The commission believes that a state reinsurance fund would alleviate the shortage of commercial reinsurance and reduce the burden on insurers and self-insurers of long-term escalating claim liability . . . *its expenses might be less and investment income available from reserves might also reduce costs to employers*. (emphasis added)

The WCRA charges premiums to its members based on actuarial projections of the number of catastrophic injuries that are likely to occur in Minnesota's work force each year, together with estimates of the costs of these catastrophic injuries. The WCRA Board of Directors annually establishes premium rates that are designed to produce enough premium dollars that, together with investment earnings over time, are sufficient to reimburse WCRA members for their catastrophic claims that exceed their chosen retention limits. If claims and operating expenses are lower than projected and investment returns are better than expected, surplus funds are periodically distributed to WCRA members and Minnesota employers. Reimbursement payments by the WCRA are made in accordance with State law and may continue for the life of a claim, which can be as long as 70 years.

The WCRA is not a State agency and has never received any State appropriations to fund its operations. It is governed by a 13-member board of directors, including the Commissioner of Finance and the executive director of the State Board of Investment; five members appointed by the Commissioner of Labor and Industry (two employer representatives, two employee representatives, and a public member); four insurer representatives elected by insurers from candidates approved by the Commissioner of Labor and Industry; and two self-insurer representatives elected by self-insurers from candidates who are also approved by the Commissioner of Labor and Industry.

When the WCRA was established, the Board contracted with one of the nation's largest private reinsurers, General Reinsurance Company, to manage the association. In 1990, after a two-year transition period, the Board transferred management to an in-house staff, which the Board believed would be more focused and cost effective.

The Legislature created the WCRA as a nonprofit association. In 1996, the WCRA sought federal tax-exempt status, which was enacted by Congress as a part of the Health Insurance Portability and Accountability Act of 1996. The association will remain tax-exempt as long as it is the exclusive provider of workers' compensation reinsurance in Minnesota and as long as it returns surplus funds to its members or workers' compensation policyholders on a periodic basis.

The WCRA's financial results have been excellent. In 22 years (through the end of 2001), it has collected $1.01 billion in premiums from its members, returned $1.23 billion in surplus funds to members and Minnesota workers' compensation policyholders, and reimbursed its members more than $356 million in claims. As of December 31, 2001, invested assets of $1 billion are actuarially sufficient to pay estimated future benefits of $3.18 billion (undiscounted) over the next 70 years on funded claims that have already been incurred.

Claims

The primary business of the WCRA is to reimburse its members for workers' compensation benefits paid to the state's seriously injured workers when members have incurred claims expenses in excess of their selected retention limits. For 2002, members selected one of three retention limits: the low retention of $350,000; the high retention of $700,000; and the super retention of $1,400,000. The WCRA's responsibilities to its members are governed by its statutory Enabling Act, its Plan of

Operation, operating rules adopted by the Board of Directors, and an annual reinsurance agreement with its members.

A member is required to report a workers' compensation injury to the WCRA claims staff when its established reserves on the claim exceed 50 percent of its WCRA retention limit, or if the injury is so serious that it is very likely to require WCRA involvement. These serious claims include fatalities, spinal cord injuries, third-degree burns, amputations, multiple fractures, and other catastrophic injuries. The following table shows the distribution of the types of severe industrial injuries reported to the WCRA.

Injury Type	Percent
Spinal injuries	52%
Multiple body	18%
Lower extremity	9%
Upper extremity	7%
Cumulative trauma	6%
Head injuries	3%
Occupational injuries	3%
Burns	2%
Total	**100%**

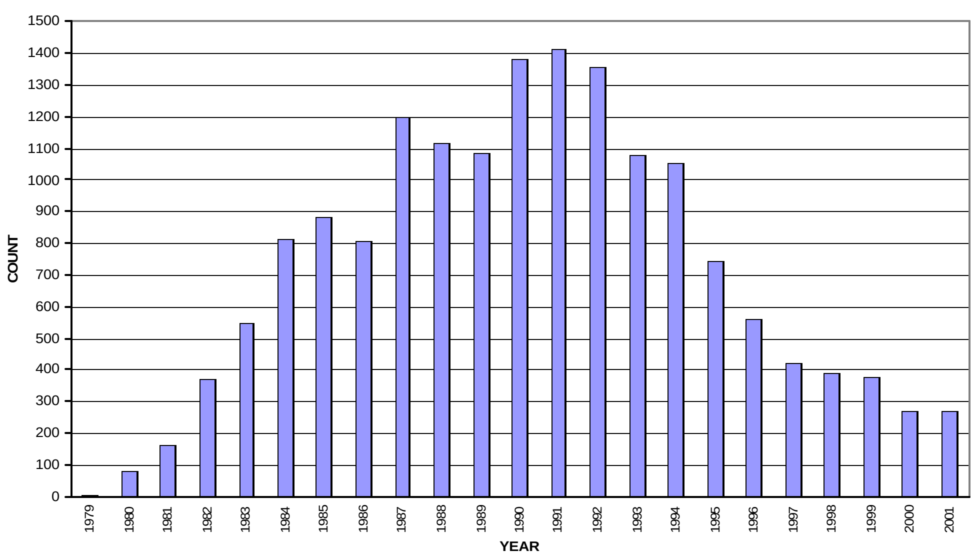
Since 1979, more than 16,000 initial claims have been submitted to the WCRA. These claims are monitored by the claims staff through regular reports from members. The graph at the bottom of the page shows the history of WCRA claims filings.

The number of claims reported annually to the WCRA has declined in recent years as a result of 1992 and 1995 statutory benefit changes and the addition of the super retention level option for WCRA members.

When a member's retention limit for the year in which the injury occurred is exceeded, the claims staff audits the indemnity and medical benefit payments made by the member and reimburses the member for all Chapter 176 workers' compensation benefits that exceed the retention limit. Periodic reimbursement payments are then made for the lifetime of the claim. The WCRA has made reimbursement payments on more than 3,000 claims totaling $356 million. In 2001, 1,976 reimbursement checks were issued for claims totaling $37.9 million.

The WCRA claims and rehabilitation staffs conduct periodic claims reviews to make certain statutory procedures are being followed. They also monitor the treatment and rehabilitation programs of seriously injured workers. The WCRA staff has reviewed all of the serious work-related injuries in the state and is available to advise members on what treatments are most effective and which providers have the most experience in treating particular work-related injuries.

WCRA INITIAL REPORTED CLAIMS



Premiums

For each upcoming year, the WCRA actuarial staff completes a detailed pricing analysis and projects the number of serious injuries it expects to occur in Minnesota that will exceed the WCRA retention limits. Next, the amounts of workers' compensation benefits which the WCRA expects to reimburse its members over the lives of those claims are calculated. The actuaries then discount the total amount of benefits that are projected to be paid to determine the amount of premiums the WCRA will need to charge its members to have sufficient funds in reserve to pay future claims for the injuries that occurred during the year. Currently the WCRA's premiums reflect a discount rate of 8 percent, while the association's reserves reflect a slightly more conservative discount rate of 7.5 percent.

Based on member retention selections for 2002, the actuaries project that the total undiscounted expected losses to be paid for all three retention limits combined will be $144 million. Applying the discount factors and adding in the expenses of administering the claims over the years, the expected premium income for 2002 is $28.4 million.

Based on the expected future costs at the low, high, or super retention limits, a rate is established for each retention. That rate is multiplied by each member's "exposure base," which approximates the workers' compensation insurance premium collected by insurer members or, for self-insurers, the estimated premium they would pay if they purchased workers' compensation insurance, to determine the premium to be charged.

The graph below illustrates the history of the actuarial rates adopted for the period 1980-2002. Note that the rates dropped dramatically in 1993 as the actuaries projected the impact of the 1992 workers' compensation law amendments and increased the pricing discount rate from 7 percent to 8 percent. The 1995 workers' compensation amendments added a super retention level, and these changes are reflected beginning in 1996. Since 1996, rates have been fairly stable, but 2002 rates were reduced by 12 percent to reflect the association's projection of lower Minnesota claims costs for the current year.

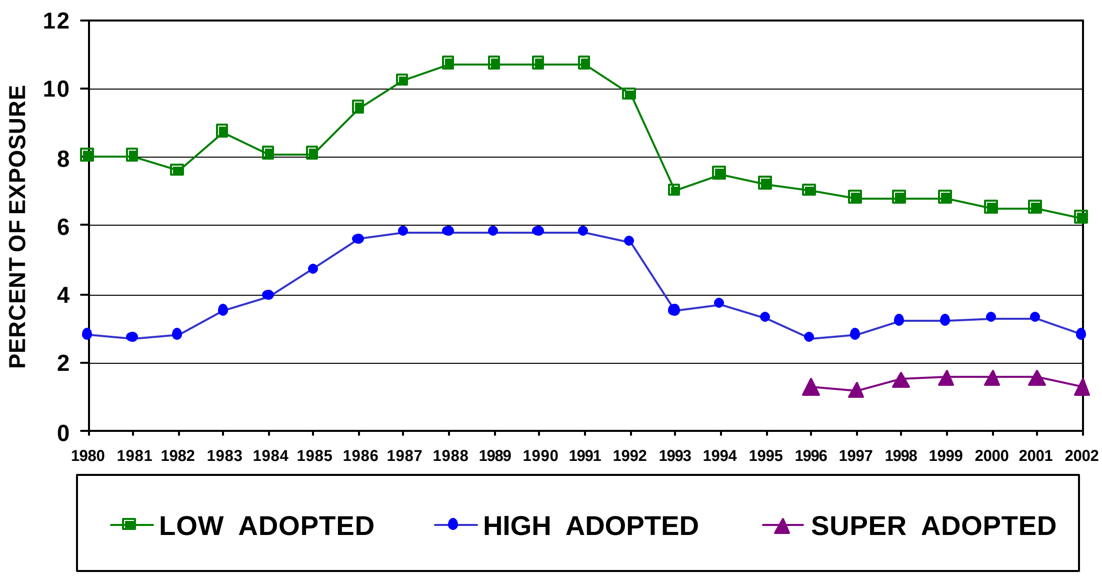
Reserves

The loss portion of the premium collected from members each year is added to the reserves of the

HISTORY OF WCRA ADOPTED RATES

1980-2002 LOW, HIGH & SUPER RETENTIONS

(Premium Credits for 1996 and 1997 are Excluded.)



WCRA and invested to generate sufficient funds to pay the WCRA's future claims liabilities on past losses. The loss portion of total 2002 premiums, $26 million, will be added to the WCRA's reserves and invested to pay future benefits for injuries that occur in 2002.

The WCRA actuaries annually review and update the actual claims experience for each prior year and compare it to the original projected losses for each year. As the WCRA has acquired more claims experience, the actuaries have found that WCRA members have generally had better-than-expected claims experience. Therefore, in recent years, the actuaries have reduced the amount of reserves they believe necessary to permit the WCRA to meet its future claims obligations for past injuries. As a result, of the $310 million in surplus funds distributed to members and policyholders in 2001, $121 million was attributable to better-than-expected claims experience in prior years and the balance to better-than-expected investment performance. Of the entire $1.23 billion in surplus funds distributed by the association since 1992, $509 million was associated with better-than-expected claims experience in prior years. As a result, the association's discounted reserves have been reduced by more than $500 million.

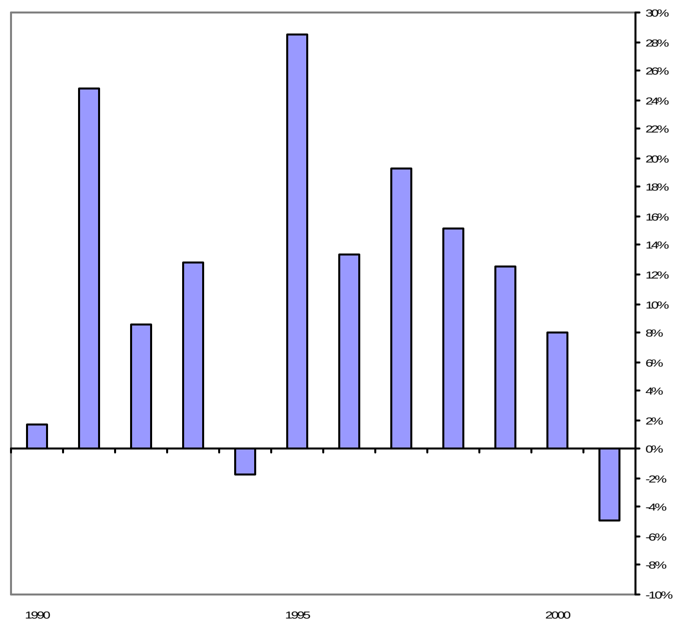
Investments

WCRA funds are invested in accordance with investment policies and guidelines adopted by the WCRA Board of Directors. The association's investment policies are developed and overseen by the Investment Committee, which is chaired by the executive director of the State Board of Investment and is composed of representatives from a number of large institutional investors in the state.

Because the WCRA's liabilities are very long term, with some claims payments projected to run for as long as 70 years, the investment portfolio is structured to generate returns that match those long-term liabilities. Unlike traditional insurance companies, which are statutorily limited to investing 25 percent of their funds in equities, the WCRA currently invests 60 percent of its funds in domestic and international equities and 40 percent in fixed income investments. The funds are placed with approximately ten outside money managers. The performance of these managers is monitored by WCRA staff and is measured against selected benchmarks that are appropriate to the investment styles and objectives of the particular manager.

The long-term investment objective for the WCRA portfolio is to earn an 8 percent overall annual rate of return. Largely as a result of the favorable investment climate during the 1990s, returns on the WCRA portfolio have substantially exceeded this benchmark. From 1979 through December 31, 2001, the portfolio earned an overall 12.7 percent average annual rate of return.

WCRA ANNUAL INVESTMENT RETURNS 1990-2001



Operations and Budget

When the Legislature created the WCRA, the new law stated that the WCRA is not a State agency and is not subject to the provisions of Chapters 14, 15, and 16 of State law, which govern the activities of State agencies. Therefore, the association was set up as an independent entity governed by a statutorily established board of directors.

Since 1990, the operations of the association have become increasingly efficient. The number of employees has been reduced from 37 to 23, and a variety of technological operating efficiencies were introduced. In addition, the association has no sales and marketing expenses and, because of its tax-exempt status, pays no taxes. Comparing the WCRA's expenses to those of private reinsurers, the operating and acquisition costs of commercial reinsurers are generally 1 percent to 2.5 percent of market premiums, whereas the WCRA's expenses are about 0.2 percent.

The WCRA's budget is approved by the Board of Directors after detailed review by the Finance and Audit Committee and the Executive Committee. Between 1990 and 2000, the total audited operating and capital expense budget increased from $2.93 million to $3.45 million, which is an annualized rate increase of 1.65 percent.

Personnel costs constitute nearly 65 percent of the 2002 budget. The Board of Directors has had a longstanding policy of establishing salaries and benefits for employees to be commensurate with those paid by comparable private insurance companies. A variety of salary market surveys are regularly collected and reviewed, and compensation scales for each position are periodically adjusted to track changes in the market. The salary of the president is set by the Board of Directors. No bonuses, stock options, or other incentive compensation are paid to individual employees. By statute, the WCRA's books and records are always open to the Commissioner of Labor and Industry for audit and examination.

Regulation of the WCRA

The WCRA is not regulated like an insurance company. The Legislature created a specific statutory structure for regulating the WCRA in Minnesota Statutes Section 79.34-.40. While this unique regulatory approach is different from traditional insurance regulation, it gives the Commissioner of Labor and Industry substantially more authority over the WCRA than the Commissioner of Commerce has over private insurers and reinsurers. The Commissioner of Labor and Industry appoints or approves 11 of the 13 Board members (the other 2 are the Commissioner of Finance and the executive director of the State Board of Investment); approves annual premium rates; approves changes to the Plan of Operation; approves excess premium distributions to members; and, after review by the Commissioner of Commerce, approves excess surplus distributions to workers' compensation policyholders.

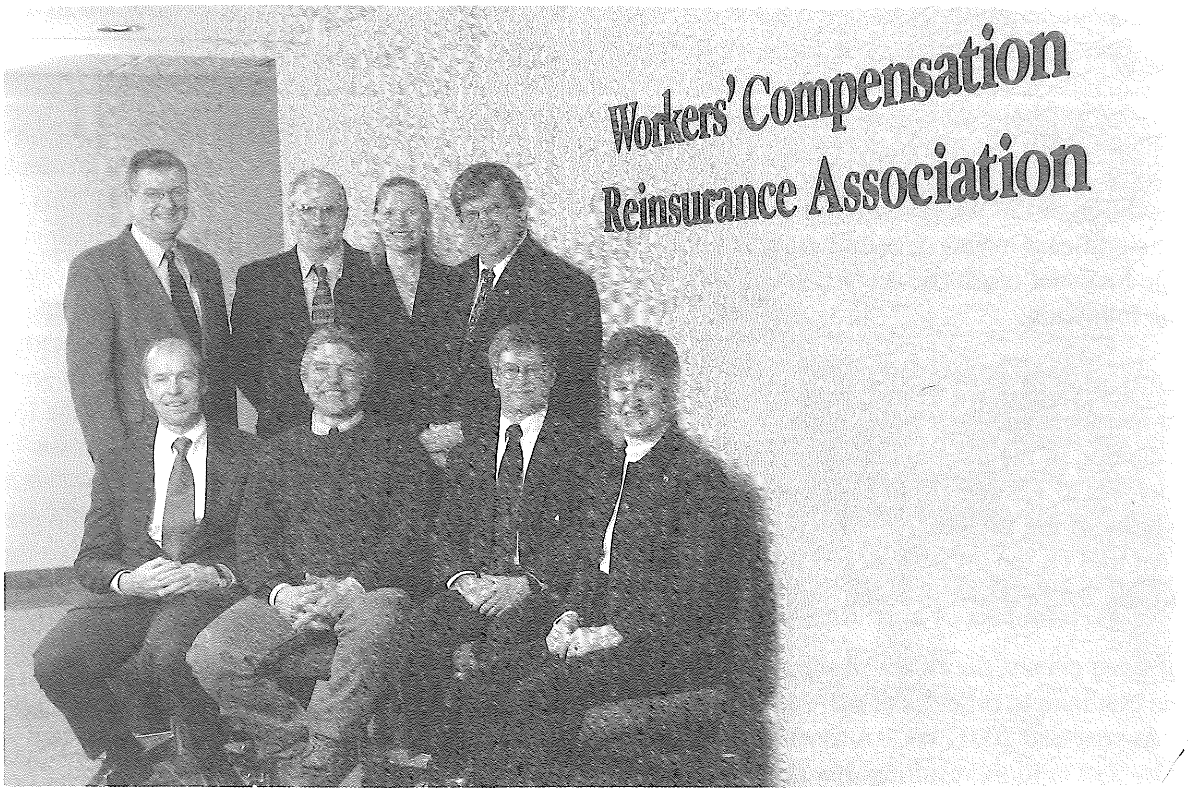
Surplus Distributions

During the first ten years of its existence, the WCRA ended each year with a small surplus or deficit. Beginning in 1989, however, it gradually developed substantial surpluses. The Commissioner of Labor and Industry urged the WCRA to distribute these excess funds to WCRA members, and in September 1992, the WCRA Board voted to distribute $100 million in excess premiums to member insurers and self-insurers. The commissioner approved this distribution, and the funds were paid to members. In February 1993, the Board approved a second excess premium distribution of $302 million.

Following the $402 million distribution to WCRA members, the 1993 Legislature amended the WCRA's Enabling Act to require that "excess surplus" funds be distributed to Minnesota workers' compensation insurance policyholders. The statute did not define what "excess surplus" is, but subsequent litigation clarified that policyholders should receive excess investment earnings on assets of the association accumulated after the 1993 amendments were adopted. The association made a third surplus distribution in 1997 totaling $471 million, of which policyholders received $35 million. The most recent surplus distribution authorized by the WCRA Board of Directors was completed in 2001. A total of $310 million was distributed, with $42.2 million going to insured Minnesota employers.

In summary, including interest and miscellaneous premium credits, $1.23 billion in surplus funds have been returned to the workers' compensation system by the WCRA since 1992.

WCRA BOARD OF DIRECTORS



Standing:	Bernard Brommer (AFL-CIO), Donald Gerdesmeier (Minnesota D.R.I.V.E.), Patricia Johnson (State Fund Mutual Insurance Company), Howard Bicker (State of Minnesota)
Sitting:	Michael Markman (Zurich Insurance Group), Hugh Fendry II (Rochester Meat Company), Gary Swoverland (Land O'Lakes), Susan Herboldt (Itasca County)
Not pictured:	Pamela Wheelock (State of Minnesota), Wayne Simoneau (public representative), David Young (Liberty Mutual Insurance Group), George Klouda (Western National Mutual Insurance Company), Bradley Robinson (Robinson Rubber Company)

MANAGEMENT'S SUMMARY ANALYSIS OF 2001 FINANCIAL RESULTS

Overview

Although 2001 was a year of dramatic industry change and market volatility, the financial condition of the WCRA remains stable. A number of significant events occurred in 2001 that affected the financial results of the WCRA. These include the following.

* Distribution of $310 million in excess funds to our members and their policyholders.
* Reduction of the discount rate for reserves from 8 percent to 7.5 percent to ensure the long-term stability of the WCRA.
* A net loss on the investment portfolio of 4.74 percent, the first loss in seven years.

In spite of these events, the financial statements of the association continue to reflect a positive financial position. At year-end 2001, WCRA assets exceeded liabilities by $86 million, resulting in a designated surplus of that amount. The Board of Directors has set a policy of maintaining surplus between -10 percent and +30 percent of the funded loss reserve liability, calculated at present value. The year-end 2001 surplus figure is 9 percent of funded reserves, a percentage near the midpoint of the surplus range established by the Board.

Excess Funds Distribution

The Board of Directors approved the distribution of excess funds to members and policyholders in December 2000. Following the required regulatory approvals of the distribution, the WCRA issued checks to self-insured members, insurer members, and workers' compensation policyholders in Minnesota in the amounts shown below.

Minnesota Self-Insurers	$ 65,600,000
Member Insurers	202,200,000
Minnesota Policyholders	42,200,000
	$ 310,000,000

Reserve Discount Rate Reduction

On March 8, 2001, the Board of Directors approved a reduction in the discount rate used for calculating reserves from 8 percent to 7.5 percent. This change was made to provide more protection against market volatility and to offer members greater assurance that the association's reserves are sufficient to pay future claims reimbursements. The WCRA expects to earn between 7 percent and 8 percent on its investment portfolio over the long term, and the new discount rate for reserves continues to fall within the range of the association's earnings expectations. At the end of 2001, the reduced reserve discount rate had the effect of increasing WCRA loss and loss expense reserves by almost $52 million and decreasing the association's surplus by the same amount.

Investment Results

The WCRA invests 60 percent of its portfolio in the stock market, which suffered its second consecutive year of negative returns in 2001. The 40 percent allocation to the US fixed income market helped offset those negative returns. The overall portfolio lost 4.74 percent for the year, while the overall US stock market dropped more than 11 percent.

Operating Results

Premiums and Losses

The WCRA earned $30.1 million in funded premiums in 2001, $3.6 million less than in the previous year. This decline is the result of stable WCRA reinsurance rates combined with lower exposure and fewer prior-year actuarial adjustments than in 2000.

Funded losses and loss expenses of $139.3 million were incurred for the fiscal year, an increase of $68.2 million from the prior year. The two major factors contributing to the increase are the stability in the loss projections (compared to last year's decrease) and the change in the reserve discount rate. Funded loss and loss expenses for the year are made up of the following items.

Discounted WCRA Funded Losses and Loss Expenses Incurred (in millions)

	2001	2000
On prior accident years:		
Present value update	$ 64.0	$ 61.4
Revisions to projected funded ultimate losses	(0.3)	(14.7)
Change in reserve discount rate	51.8	0
	115.5	46.7
On the current accident year:	23.8	24.4
Total funded losses and LE incurred	$ 139.3	$ 71.1

Claim reimbursements to members were $37.9 million, which is consistent with the association's projections of gradually increasing reimbursement levels.

Investment Performance

The investment portfolio lost $66.3 million in 2001. This resulted in a total rate of return of -4.74 percent, which represented an underperformance relative to the WCRA benchmark portfolio return of -4.5 percent. In addition, it fell short of the $64 million required to match the present value update of the funded reserves. The investment returns are reported on the Statement of Operations as follows (in thousands).

Investment Income, net of related expenses	$35,061
Net realized investment losses	(50,449)
Change in unrealized loss on securities	(50,952)
	($66,340)

The WCRA reports its financial statements in accordance with Generally Accepted Accounting Principles (GAAP). Financial Accounting Standards Board 115 requires that the association recognize as realized losses any unrealized losses where the value of the asset is deemed to be impaired. As of December 31, 2001, the WCRA had $8.7 million of unrealized losses that were reclassified as net realized investment losses.

The association also earned $2.5 million in restricted investment income, which represents the interest earned on the money set aside to pay the surplus funds distribution.

Net Results

The WCRA reported a net loss of $124.8 million and a comprehensive loss of $175.8 million on total revenues of $26.6 million for 2001. These losses are primarily attributable to a loss on investments of $66.3 million and the decision to lower the discount rate for reserves to 7.5 percent. The change in the discount rate reduces net income but ensures that the WCRA sets aside an additional $51.8 million in funded reserves.

Financial Condition

Assets

The WCRA reported assets of $1.52 billion as of December 31, 2001, a decline of $503 million from the previous year. The decline in asset values is due to the payment of $310 million in excess funds to WCRA members and their policyholders, and a reduction in the market value of the investment portfolio.

In addition to the market value of the investment portfolio, the other significant asset is $75 million deferred for unfunded losses. This represents money that the WCRA would collect from its members if the association were to make actual payments on losses in excess of the prefunded limits as provided in State law and in the reinsurance agreements between the WCRA and its members.

GAAP requires that the assets held as collateral as part of a securities lending program be included with the assets on the balance sheet and that the amounts payable under the same agreements be included as liabilities. The reconciliation of the financial statement totals to the market value of the investment portfolio is shown (in thousands) in the following table.

Reconciliation of Investment Portfolio Value

Total Investments	$ 1,349,264
Accrued Investment Income	4,324
Due from Securities Brokers	87,451
Payable under Securities Loan Agreement	(225,389)
Due to Securities Brokers	(211,358)
Market Value of Investment Portfolio	$ 1,004,292

reserves in 2001 as shown below (in thousands). Only the change in the reserve discount rate had any material impact on the association's surplus.

Present Value Update (calculated at 8% discount)	$ 63,995
Change in Reserve Discount Rate	51,782
Reserves for Current Accident Year	23,838
Payments on Prior Accident Years	(37,883)
Prior Year Impact of Actuarial Adjustments	(273)
Increase in Funded Reserves in 2001	$101,459

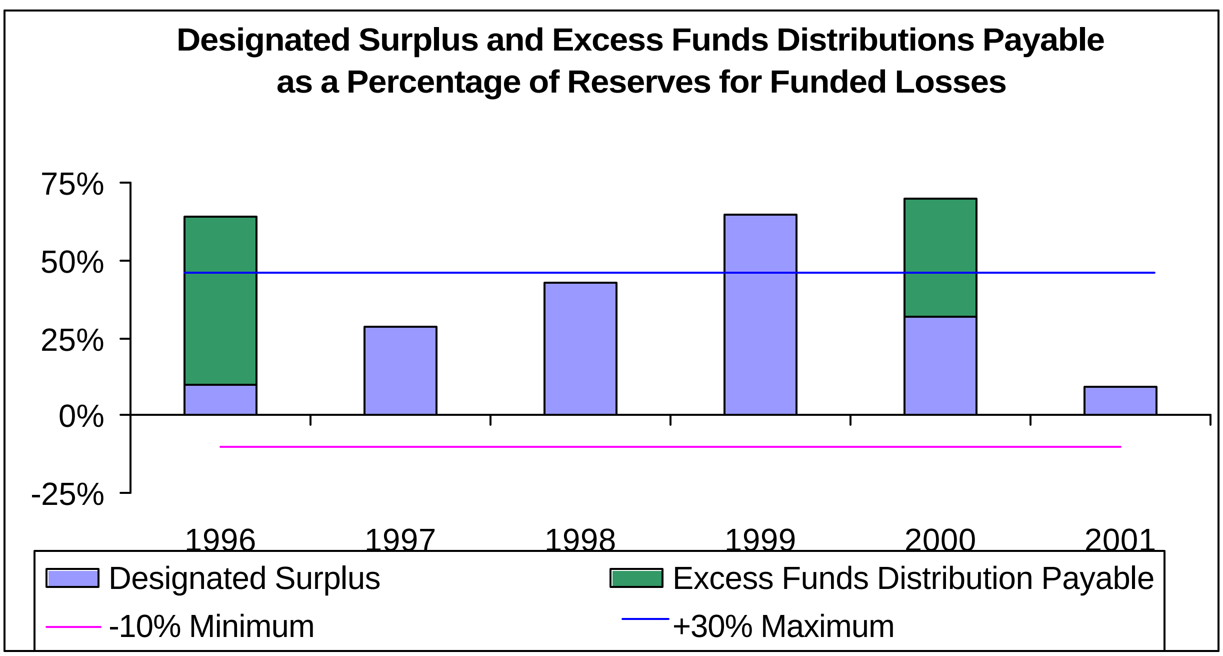
Liabilities

The WCRA reported total liabilities of $1.43 billion on December 31, 2001, compared to $1.76 billion in the prior year. The decline in liabilities is largely due to the payment of $310 million in excess funds distribution that the WCRA paid to its members and their policyholders.

The most significant liability is the reserve for funded losses and loss expenses, which was reported at $920 million for 2001 versus $819 million in 2000. The increase in this liability is due to the actuarial adjustments made to the

Designated Surplus

The WCRA reported a designated surplus of $86 million on December 31, 2001. Following the distribution of 1996 excess funds, the Board of Directors determined that designated surplus should be no less than -10 percent and no more than 30 percent of the present value of the funded reserves. This range assumes that present value calculations use the current reserve discount rate of 7.5 percent. The designated surplus at year-end 2001 represents 9 percent of the year-end funded reserves, a result that is approximately at the midpoint of this range.



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, 2001 and 2000, 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 Company'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.

February 21, 2002

PricewaterhouseCoopers LLP

WORKERS' COMPENSATION REINSURANCE ASSOCIATION
Balance Sheets
At December 31, 2001 and 2000
(In thousands)

ASSETS	**2001**	**2000**
Investments, at market value:		
Cash and cash equivalents (including securities lending collateral of $225,389 and $263,859 at December 31, 2001 and 2000, respectively)	$ 253,901	$ 310,109
Common and preferred stock	601,017	806,963
Bonds	494,346	727,811
Total investments	1,349,264	1,844,883
Restricted cash and cash equivalents	1,802	--
Uncollected reinsurance premiums:		
Due for funded losses	307	29
Deferred for unfunded losses	75,072	65,656
Total uncollected reinsurance premiums	75,379	65,685
Accrued investment income	4,324	7,091
Due from securities brokers	87,451	103,307
Accounts receivable and prepaid expenses	82	154
Property and equipment, less accumulated depreciation of $781 and $640 at December 31, 2001 and 2000, respectively	394	450
Total assets	$ 1,518,696	$ 2,021,570
LIABILITIES AND SURPLUS		
Liabilities:		
Losses and loss expenses:		
Funded	$ 920,337	$ 818,878
Unfunded	75,072	65,656
Total losses and loss expenses	995,409	884,534
Payable under securities loan agreement	225,389	263,859
Due to securities brokers	211,358	301,061
Excess funds distribution payable (Note 4)	17	309,837
Accounts payable and accrued expenses	253	238
Total liabilities	1,432,426	1,759,529
Contingencies		
Surplus from operations	40,592	165,411
Accumulated other comprehensive income	45,678	96,630
Designated surplus (Note 2)	86,270	262,041
Total liabilities and surplus	$ 1,518,696	$ 2,021,570

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, 2001 and 2000
(In thousands)

	2001	2000
Revenues:		
Reinsurance premiums:		
Funded	$ 30,110	$ 33,733
Unfunded	9,417	(10,103)
Premiums earned	39,527	23,630
Investment income, net of related expenses	35,061	44,475
Net realized investment (loss) gains	(50,449)	106,120
Restricted investment income, net of related expenses	2,467	-
Total revenues	26,606	174,225
Expenses:		
Losses and loss expenses:		
Funded	139,350	71,176
Unfunded	9,417	(10,103)
Losses and loss expenses incurred	148,767	61,073
Operating and administrative expenses	2,658	2,203
Total expenses	151,425	63,276
Net (loss) income	(124,819)	110,949
Other comprehensive (loss) income:		
Change in unrealized losses on securities	(50,952)	(49,097)
Comprehensive (loss) income	(175,771)	61,852
Surplus, beginning of year	262,041	510,026
Excess funds distribution	-	(309,837)
Surplus, end of year	$ 86,270	$ 262,041

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, 2001 and 2000
(In thousands)

	2001	2000
Cash flows from operating activities:		
Funded premiums collected	$ 29,833	$ 33,883
Interest and dividends received, net of related expenses	35,030	42,389
Loss and loss expenses paid	(37,891)	(39,430)
Operating and administrative expenses paid	(2,416)	(2,284)
Net cash provided by operating activities	24,556	34,558
Cash flows from investing activities:		
Sale of investments:		
Common and preferred stocks	698,947	1,064,539
Bonds	3,476,451	2,176,298
Purchase of investments:		
Common and preferred stocks	(603,792)	(1,059,547)
Bonds	(3,304,644)	(2,228,540)
Collateral for securities on loan	(38,470)	30,048
Restricted cash and cash equivalents	665	3
Purchase of equipment	(100)	(136)
Net cash provided by (used in) investing activities	229,057	(17,335)
Cash flows from financing activities:		
Payments on excess funds distribution payable	(309,821)	--
Net cash used in financing activities	(309,821)	--
Change in cash and cash equivalents	(56,208)	17,223
Cash and cash equivalents, beginning of year	310,109	292,886
Cash and cash equivalents, end of year	$ 253,901	$ 310,109

The accompanying notes are an integral part of the financial statements

WORKERS' COMPENSATION REINSURANCE ASSOCIATION
Notes to Financial Statements

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 rules and 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 authorized to self-insure their workers' compensation liabilities in Minnesota are required to be members of the Association.

Retention Limit

For 2001, members selected one of three maximum per loss occurrence retention limits, which were $330,000, $660,000 or $1,320,000. For 2000, members selected one of three maximum per loss occurrence retention limits, which were $310,000, $620,000 or $1,240,000. Retention limits increase annually based on a formula prescribed in the Enabling Act. 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 $6.6 million per occurrence for 2001 ($6.2 million per occurrence for 2000) for funded losses reinsured by the Association;

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

* loss, operating, and administrative expenses of the Association (loss 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 member's selected retention limit; and (2) the member's 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 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.

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 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.

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 unrealized gains and losses (other comprehensive income) on available-for-sale securities.

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.

Restricted Cash and Cash Equivalents

Restricted cash and cash equivalents relate to amounts restricted for payment of the excess funds distribution payable. Interest earnings thereon are also restricted for payment of the excess funds distribution payable and related expenses. (For discussion of excess surplus distribution, see Note 4).

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.

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 loss and loss expenses. The Board has determined that up to 30 percent of funded losses should be retained and reflected on the balance sheet for designated surplus. These provisions are 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 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 and applicable provisions of the Plan.

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

Losses and Loss Expenses
The liability for funded losses and loss expenses represents the present value, discounted using 7.5 percent for December 31, 2001, and 8 percent for December 31, 2000, 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 7.5 percent for December 31, 2001, and 8 percent for December 31, 2000, 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.

The liability for losses and loss expenses at December 31, 2001 and 2000 is summarized as follows (in thousands):

	2001	**2000**
Funded, undiscounted	$ 3,183,736	$ 3,084,814
Discount	(2,263,399)	(2,265,936)
	920,337	818,878
Unfunded, undiscounted	1,023,174	1,274,634
Discount	(948,102)	(1,208,978)
	75,072	65,656
Total	$ 995,409	$ 884,534

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

	2001	**2000**
Balance, January 1:		
Funded, undiscounted	$ 3,084,814	$ 3,043,982
Incurred related to:		
Current year	136,301	152,866
Prior years	512	(72,604)
Total incurred	136,813	80,262
Paid related to:		
Current year	8	40
Prior years	37,883	39,390
Total paid	37,891	39,430
Balance, December 31:		
Funded, undiscounted	3,183,736	3,084,814
Discount	(2,263,399)	(2,265,936)
	$ 920,337	$ 818,878

Reserves are reviewed periodically and updated based on current claims experience and trends. Adjustments to the estimated liability for losses and loss 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.

Change in Reserve Discount Rate

One significant change impacting year-end 2001 reserve levels is the reduction in the reserve discount rate from 8 percent at December 31, 2000, to 7.5 percent. This change was approved by the Board on March 8, 2001, and is effective for reserves on and after March 9, 2001. At year-end 2001, this change increases WCRA funded loss and loss expense reserves by approximately $52 million.

The following chart compares all of the funded reserve changes during 2001 with those of 2000 on a discounted basis (in thousands).

Present Value of Funded Reserve Changes	**2001**	**2000**
Funded reserves as of prior year-end	$ 818,878	$ 787,132
Prior year impact of actuarial adjustments (discounted at 8%)	(273)	(14,674)
Payments on prior accident years	(37,883)	(39,390)
Present value update (calculated at 8%)	63,995	61,396
Reserves for current accident year (discounted at 8%)	23,838	24,414
Change in reserve discount rate from 8% to 7.5%	51,782	--
Total of funded reserve changes during calendar year	101,459	31,746
Funded reserves as of year-end	$ 920,337	$ 818,878

The prior year impact of funded actuarial adjustments during 2001 is much smaller than it was in 2000, serving to stabilize WCRA funded reserve levels aside from the change in discount rate. In 2001, actuarial adjustments on prior accident years, including changes in selected ultimate loss and loss expense amounts, decreased funded discounted reserves by $273,000. The prior year impact of these funded actuarial adjustments is a combination of the following factors quantified below (in thousands, discounted at 8 percent).

Prior Year Impact of Funded Actuarial Adjustments in 2001	**December 31, 2001 Impact on Funded Undiscounted Ultimate Loss and Loss Expense**	**December 31, 2001 Impact on Funded Discounted (8%) Loss and Loss Expense Reserves**
Annual adjustment of actuarial credibility weights	$ (58,911)	$ (17,007)
Upward loss development	67,757	9,109
Pricing assumption updates	(85,928)	(373)
Enhanced loss expense methodology	77,594	7,998
2001 funded prior year impact (discounted at 8%)	$ 512	$ (273)

WCRA reserve calculations blend indicated reserves from the claims experience with the Association's pricing assumptions. Each year the Association adjusts the credibility weights used in its reserve analyses to assign more weight to the data of known claims and less weight to the theoretical assumptions made during the pricing process.

In addition to this year's change in discount rate, two major actuarial enhancements were implemented for 2001 reserves. The first major actuarial reserve change updated the pricing assumptions used in our reserve analysis. Updated frequency assumptions decreased the expected number of claims while updates to the pricing models increased other theoretical assumptions. Some of the more significant enhancements done to the pricing models include the cessation of permanent total indemnity benefits after age 67 (based on the 1995 Minnesota law), updates of settlement assumptions, an overhaul to claimant age assumptions, and a medical parameter update.

The second major actuarial reserve change enhanced the funded loss expense reserve calculations, allowing the WCRA to achieve greater consistency in pricing and reserving for loss expenses. The enhanced funded loss expense reserves reflect both an accounting and an actuarial change. The change in accounting estimate involves a clearer definition of the split between loss expenses and all other expenses of the Association. The actuarial enhancement yields loss expense reserves that are based on projected future costs of reporting, maintaining and closing WCRA claims.

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

In December 2000, 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 expense reserves and positive investment performance. As a result, on March 8, 2001, the Board declared a distribution of $310 million, which is equal to the Association's year-end 2000 adjusted surplus, less an amount equal to 32 percent of the funded loss and loss expense reserves, discounted at 8 percent, as calculated in accordance with the Operating Rule for the Determination of Surplus. These funds were distributed during 2001 as follows (in millions):

Minnesota policyholders	$ 42
Member self-insurers	66
Member insurers	202
	$ 310

5. Cash Flows

A reconciliation of net income to net cash provided by operating activities for the years ended December 31, 2001 and 2000, is as follows (in thousands):

	2001	2000
Net income	$ (124,819)	$ 110,949
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized investment losses (gains)	50,449	(106,120)
(Increase) decrease in funded uncollected reinsurance premiums, net of accrued premium adjustments	(278)	150
Increase in liability for funded losses and loss expenses	101,459	31,746
Other, net	(2,255)	(2,167)
Total adjustments	149,375	(76,391)
Net cash provided by operating activities	$ 24,556	$ 34,558

6. Investments

The cost of common and preferred stocks, amortized cost of bonds, and estimated fair values at December 31, 2001 and 2000, respectively, are as follows (in thousands):

	2001			
	Cost/ Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Common stocks	$ 554,907	$ 73,794	$ (31,931)	$ 596,770
Preferred stocks	4,398	131	(282)	4,247
Total stocks	$ 559,305	$ 73,925	$ (32,213)	$ 601,017
U.S. Treasury securities and obligations of U.S. government and agencies	$ 102,737	$ 548	$ (1,174)	$ 102,111
Corporate debt securities	212,837	3,334	(2,107)	214,064
Mortgage backed securities	174,806	4,333	(968)	178,171
Total bonds	$ 490,380	$ 8,215	$ (4,249)	$ 494,346

	2000			
	Cost/ Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Common stocks	$ 711,641	$ 152,052	$ (61,521)	$ 802,172
Preferred stocks	5,126	---	(335)	4,791
Total stocks	$ 716,767	$ 152,052	$ (61,856)	$ 806,963
U.S. Treasury securities and obligations of U.S. government and agencies	$ 120,751	$ 3,150	$ (384)	$ 123,517
Corporate debt securities	298,321	5,132	(7,043)	296,410
Mortgage backed securities	302,305	6,374	(795)	307,884
Total bonds	$ 721,377	$ 14,656	$ (8,222)	$ 727,811

The amortized cost and estimated fair value of debt securities at December 31, 2001, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 10,806	$ 10,863
Due after one year through five years	71,088	71,609
Due after five years through ten years	115,853	115,895
Due after ten years	292,633	295,979
Total	$ 490,380	$494,346

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.

During 2001, 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 basis of the individual securities were written down to fair value as the new cost basis and the total amount of the write-down of approximately $8.7 million was recorded in earnings as a realized loss.

Other comprehensive income in 2001 and 2000 is comprised of only the change in unrealized gains (losses) on available-for-sale securities arising during the year less realized gains (losses) included in income as follows:

	2001	2000
Unrealized holding (loss) gains	$ (101,401)	$ 57,023
Reclassification adjustment for (loss) gains included in net income	50,449	(106,120)
Net other comprehensive loss	$ (50,952)	$ (49,097)

Gross gains of $195 million and $274 million and gross losses of $237 million and $168 million were realized on sales of investments during 2001 and 2000, respectively. Net investment income and net realized investment gains (losses) during the years ended December 31, 2001 and 2000, are summarized below (in thousands):

	Net Investment Income		Net Realized Gains (Losses)	
	2001	**2000**	**2001**	**2000**
Securities lending	$ 336	$ 366	$ ---	$ ---
Cash and cash equivalents	2,852	3,577	(548)	3,466
Common and preferred stocks	8,383	10,165	(61,244)	102,343
Bonds	27,988	35,543	11,343	311
Miscellaneous	189	390	---	---
	39,748	50,041	$ (50,449)	$ 106,120
Investment expenses	(4,687)	(5,566)		
	$ 35,061	$ 44,475		

To enhance the return on investments, the Association maintains a securities lending program. At December 31, 2001 and 2000, the Association had equity and fixed income securities with fair values of $218 million and $254 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.

The Association reflects the collateral received for securities on loan on the balance sheet if the secured party has control over the collateral. An asset of approximately $225 million and $264 million and the related liability representing the collateral received is reflected on the balance sheet at December 31, 2001 and 2000, respectively.

To further enhance the return on investments, some of the Association's investment managers have entered into interest-rate future, stock index 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. Future contracts are marked-to-market on a daily basis with the gain or loss reported in income. Option contracts are valued at fair value with the gain or loss reported in income at the time the option is exercised or the contract is settled. Interest rate swaps are recorded at market value and unrealized gains and losses are recognized currently in income.

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