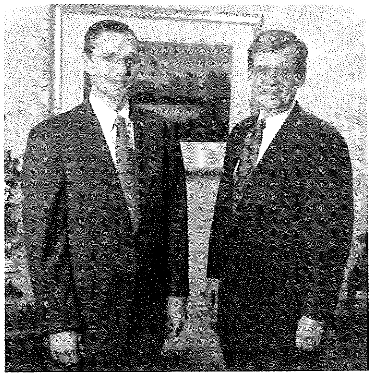
rs’ Compensation Reinsurance Association®

WCRA®

Annual Report 2002

t Street North, Suite 1700, St. Paul, MN 55101

As your new Board chair and chief executive officer, we have the privilege of writing our first management letter following a year of significant transitions at the WCRA. We are pleased to report on the many important changes that occurred in the Association during 2002.



Terrorism Protection

During the year, the insurance industry became increasingly concerned about the potential financial impact of new acts of terrorism following the tragedy of September 11, 2001. As the exclusive provider of reinsurance for workers' compensation in Minnesota, the Association recognized that all of the excess workers' compensation risk losses resulting from a catastrophic terrorist attack in the state would be funneled into the WCRA and its members. As Congress debated the merits of creating a federal terrorism insurance program, we asked Congressman Jim Ramstad to assist the WCRA in making certain that the Minnesota workers' compensation system would be adequately protected under such a program. These efforts were successful, and the Terrorism Risk Insurance Act of 2002 (TRIA), enacted in November, included a provision authorizing the Secretary of the Treasury to include "State workers' compensation reinsurance pools" like the WCRA in the new Terrorism Insurance Program. Following discussions with Treasury Department officials, we are optimistic that the WCRA will be included as a direct insurer under TRIA, which will provide excellent coverage for workers' compensation claims incurred in any terrorist event in Minnesota. The WCRA Board recognized that, even if the Association receives favorable treatment under TRIA, it provides no coverage for domestic terrorist attacks; and the retentions, deductibles, and recoupments required under TRIA would still be costly to the Association's members. For that reason, the Board authorized the purchase of $50 million in domestic and international terrorism coverage, which includes nuclear, biological, and chemical attacks. The policy is effective January 1, 2003, for a three-year period. The Board decided that the $2.8 million annual cost of this coverage should be recovered as part of the Association's premiums to be collected in 2004, 2005, and 2006.

Rate Stability

Since the events of September 11, the markets for workers' compensation catastrophic reinsurance have hardened. According to various industry sources, reinsurance rates have risen by 100 percent to 2,000 percent. In contrast, the WCRA Board of Directors approved a 12 percent rate reduction for 2002 and a 5 percent increase for 2003—a net rate decrease of 7 percent over the last two years. As a result, WCRA rates have remained very stable and are actually lower today than they were in 1998.

Financial Results

In 2002, the WCRA incurred a comprehensive loss of $194 million and closed the year with an accumulated deficit of $105 million. This loss and the accumulated deficit were primarily due to continued deterioration in the investment markets. We continued to manage operating expenses carefully, and premium revenues met expectations. Fortunately, the Association's operations generated positive cash flows, providing the liquidity necessary to meet all of the WCRA's obligations.

Investment Performance

For the second straight year, market conditions resulted in a loss in value of our investment portfolio. For 2002, our portfolio had an overall return of -8.74 percent. This followed a return of -4.74 percent in 2001. The Association is a long-term investor and maintains an asset allocation of 60 percent in domestic and international equities and 40 percent fixed income investments. This strategy is designed to produce a long-term annual return of 7.5 percent, which will allow the Association to meet its long-term claims obligations. The Association's Investment Committee carefully monitors the investment strategy and has advised the Board that these allocations remain appropriate based on the WCRA's long-term investment horizon.

Claims Management

The WCRA claims staff processed more than 2,000 reimbursement requests during the year and paid out a record $46.6 million in reimbursements to members. This amount compares to the $37.9 million paid out in 2001 and continues the expected trend of annual increases in WCRA claims reimbursements to members. The volume of business the claims staff conducts electronically continues to expand rapidly. Seventeen percent of all reimbursements received by the Association were submitted on-line by eMembers of the WCRA. eMembership provides access to a secure site where members can obtain claims, premium, and contact information for their individual companies and can also submit claims electronically.

Management and Governance

In April, following a national search, the Board of Directors selected Carl "Buzz" Cummins as the new president and chief executive officer of the WCRA. He succeeds Jay Benanav, who served as the Association's president and CEO from 1990 until his resignation on December 1, 2001. Cummins had been vice president and general counsel for the Association since 1993, and had served as the Association's acting president since September 2001, when Benanav took a leave of absence to run for mayor of St. Paul. Cummins' career includes experience as a practicing attorney, legal counsel to a former governor, and eight years in corporate management prior to joining the WCRA. His breadth of experience and his nine years in management at the Association make him well suited to lead the WCRA.

Donald Swanson joined the Association in June as its new director of finance and treasurer. Swanson, a CPA, has significant financial management experience in the property-liability insurance industry. He served in a variety of financial management positions at The St. Paul Companies, and most recently was vice president of finance for the Northland Insurance Companies.

In November, long-time Board chair Michael Markman resigned from the Board because of the new demands on his time required by his promotion to the position of executive vice president of the Commercial Business Group of North American for Zurich Insurance Company. While serving as Commissioner of Insurance, Markman was instrumental in the creation of the WCRA, was subsequently elected to the Association's Board of Directors in 1985, and became Board chair in 1986. He made great contributions to the success of the Association, and his leadership and experience will be missed. Kathryn Lovaas of The St. Paul Companies was appointed to complete the balance of Markman's term on the Board.

In December, the Board of Directors elected David Young to succeed Markman as Board chair. Young recently joined Zurich Insurance Company after 15 years with Liberty Mutual

Insurance Company. He joined the WCRA Board in 2000, chairs the Association's Actuarial Committee, and was elected vice chair of the Board in 2001.

During the year, director Pamela Wheelock also left the Board when she resigned her position as Minnesota Commissioner of Finance. Her contributions to the Association are much appreciated. She was succeeded on the Board by Assistant Commissioner of Finance Peter Sausen.

Looking ahead, we at the WCRA will continue to explore new ways to better serve our members. The success the Association has had in providing reliable, cost-effective reinsurance to the workers' compensation system in Minnesota is being increasingly recognized as a number of other states consider emulating the WCRA model.

David R. Young

Carl Cummins III

WCRA BOARD OF DIRECTORS

Standing: Peter Sausen; Donald Gerdesmeier; Patricia Johnson; Bernard Brommer: Hugh Fendry II; David Young
Sitting: Howard Bicker; Kathryn Lovaas; Bradley Robinson; Susan Herboldt; Gary Swoverland
Not pictured: Wayne Simoneau; George Klouda

MANAGEMENT'S SUMMARY ANALYSIS OF 2002 FINANCIAL RESULTS

Overview

The year 2002 was a difficult financial year for the WCRA. The Association incurred a comprehensive loss of $194 million and closed the year with an accumulated deficit of $105 million. These results were primarily due to continued deterioration of the domestic and international investment markets. The investment portfolio had a net loss of 8.74 percent for the year, the second straight year of negative investment performance.

At year-end 2002, WCRA liabilities exceeded assets by $105 million. The Board of Directors has established a guideline of maintaining surplus between -10 percent and +30 percent of the funded loss reserve liability, calculated at present value. The year-end 2002 surplus was -10 percent of funded reserves, a percentage at the lower end of the surplus range established by the Board.

In spite of these events, the WCRA maintains sufficient liquidity to meet all of its financial obligations. For 2002, cash flow from operating activities was positive, as premiums collected, loss and loss expenses paid, and operating expenses were all in line with expectations.

Operating Results and Comprehensive Loss

Premiums and Losses

The WCRA earned $30 million in funded premiums in 2002, approximately the same as in the previous year. Level premiums were the result of the offsetting impact of a decline in WCRA reinsurance rates and an increase in exposure.

Funded losses and loss expenses incurred were $134 million, a decrease of $5 million from the prior year of $139 million. This decrease primarily resulted from a change in reserve discount rate in 2001 that did not reoccur in 2002, partially offset by an increase in actuarial adjustments. An update in Minnesota life expectancy assumptions was the primary reason for the prior year impact of actuarial adjustments. The components of funded loss and loss expenses are outlined below (in millions).

Funded Losses and Loss Expenses Incurred Discounted

	2002	**2001**
Prior accident years:		
Present value update	$ 67	$ 64
Actuarial adjustments	35	--
Change in reserve discount rate	--	52
	102	116
Current accident year	32	23
Total funded losses and LE incurred	$ 134	$ 139

Investment Performance

The investment portfolio experienced a significant decline in 2002 with a total rate of return of -8.7 percent, on top of a return of -4.7 percent in 2001. The 2002 return was primarily due to continued deterioration of the domestic and international stock markets. Domestic stocks returned -22 percent and international stocks returned -13 percent. The components of investment results are shown in the following table (in millions).

	2002	2001
Investment income, net of related expenses	$ 26	$ 35
Net realized investment losses	(47)	(50)
Change in unrealized loss on securities	(67)	(51)
Total investment results	$ (88)	$ (66)

During 2002, the Association determined that the decline in fair value of certain investments was other than temporary. As a result, the cost basis of these securities was written down to market value and $15.9 million of unrealized losses was reclassified realized investment losses.

Net Loss and Comprehensive Loss

The WCRA incurred a net loss of $128 million and a comprehensive loss of $194 million. Comprehensive loss consists of net loss and the change in unrealized loss on investments. The net loss and comprehensive loss were primarily due to the significant shortfall in investment performance and the resulting gap between the actual investment return of -8.7 percent and the assumed investment return of 7.5 percent. In addition, the increase in prior year loss reserves due to actuarial adjustments contributed to the net loss and comprehensive loss.

Balance Sheet

Assets and Liabilities

Total assets were $1.30 billion at year-end 2002 compared with $1.52 billion at the end of the previous year. The decline in total assets was primarily due to the decline in the market value of the investment portfolio.

Total liabilities were $1.40 billion at December 31, 2002, down slightly from liabilities of $1.43 at the end of 2001. The decline in liabilities was the result of offsetting factors. Decreases in amounts payable under securities loan agreements and amounts due to securities brokers on investment transactions were partially offset by an increase in loss and loss expense reserves.

The WCRA's largest liability is the reserve for funded losses and loss expenses. This liability totaled $1,008 million at year-end 2002 compared with $920 million at the end of 2001. This liability represents the present value, discounted at 7.5 percent, of the total estimated obligation for losses and loss expenses for unpaid amounts up to the prefunded limit. Because this liability involves claims that will be paid out over a period of many years, judgments as to the ultimate exposure are an important component of the loss reserving process. Reserves are reviewed on a regular basis using a variety of actuarial techniques and are adjusted based on loss experience and as new information becomes available. Changes in the discounted liability for funded loss and loss expenses are shown in the following table (in millions).

	2002	2001
Funded reserves as of January 1	$ 920	$ 819
Losses and loss expenses incurred:		
Prior accident years	102	116
Current accident year	32	23
Total incurred	134	139
Losses and loss expenses paid	(46)	(38)
Funded reserves as of December 31	$1,008	$ 920

The components of prior accident year incurred losses and loss expenses are discussed above under "Operating Results."

Deficit

At year-end 2002, the WCRA had an accumulated deficit of $105 million compared with a surplus of $86 million at the end of 2001. This $191 million reduction in surplus was primarily due to investment results. The Board of Directors has set a guideline of maintaining surplus between -10 percent and +30 percent of the funded loss reserve liability, calculated at present value. The year-end 2002 surplus was at the lower end of this range, representing -10 percent of funded reserves.

Cash Flow

During 2002, cash flow was positive and provided the liquidity necessary for the WCRA to meet its financial obligations. Cash flow from operating activities was $9 million in 2002 compared with $25 million in 2001. This reduction in operating cash flow was the result of a decline in interest and dividends from investments combined with an expected increase in loss and loss expense payments.

WCRA SENIOR MANAGEMENT

Standing: Donald Swanson, Director Finance and Treasurer; Cynthia Smith, Vice President - Administration
Sitting: Jane Jasper Krumrie, Vice President and Actuary; Carl Cummins, President and CEO; Elisabeth Skoglund, Vice President - Claims and Information Systems

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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, 2002 and 2001, 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.

PricewaterhouseCoopers LLP

February 11, 2003

WORKERS' COMPENSATION REINSURANCE ASSOCIATION
Balance Sheets
At December 31, 2002 and 2001
(In thousands)

ASSETS	2002	2001
Investments, at market value:		
Cash and cash equivalents (including securities lending collateral of $177,638 and $225,389 at December 31, 2002 and 2001, respectively)	$ 273,556	$ 253,901
Common and preferred stock	514,334	601,017
Bonds	380,575	494,346
Total investments	1,168,465	1,349,264
Restricted cash and cash equivalents	--	1,802
Uncollected reinsurance premiums:		
Due for funded losses	147	307
Deferred for unfunded losses	86,114	75,072
Total uncollected reinsurance premiums	86,261	75,379
Accrued investment income	3,419	4,324
Due from securities brokers	37,750	87,451
Prepaid expenses and other assets	64	82
Property and equipment, less accumulated depreciation of $736 and $781 at December 31, 2002 and 2001, respectively	283	394
Total assets	$ 1,296,242	$ 1,518,696

LIABILITIES AND SURPLUS	2002	2001
Liabilities:		
Losses and loss expenses:		
Funded	$ 1,008,148	$ 920,337
Unfunded	86,114	75,072
Total losses and loss expenses	1,094,262	995,409
Payable under securities loan agreement	177,638	225,389
Due to securities brokers	129,068	211,358
Accounts payable and accrued expenses	575	270
Total liabilities	1,401,543	1,432,426
Accumulated (deficit) surplus from operations	(84,450)	40,592
Accumulated other comprehensive (loss) income	(20,851)	45,678
Designated (deficit) surplus (Note 2)	(105,301)	86,270
Total liabilities and surplus	$ 1,296,242	$ 1,518,696

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, 2002 and 2001
(In thousands)

	2002	2001
Revenues:		
Reinsurance premiums:		
Funded earned	$ 29,890	$ 30,110
Unfunded deferred	11,041	9,417
Investment income, net of related expenses	25,616	35,061
Net realized investment loss	(46,500)	(50,449)
Restricted investment (loss) income, net of related expenses	(82)	2,467
Total revenues	19,965	26,606
Expenses:		
Losses and loss expenses:		
Funded	134,391	139,350
Unfunded	11,041	9,417
Losses and loss expenses incurred	145,432	148,767
Operating and administrative expenses	2,186	2,658
Total expenses	147,618	151,425
Net loss	(127,653)	(124,819)
Other comprehensive loss:		
Change in unrealized losses on securities and foreign currency translation adjustment (Note 6)	(66,529)	(50,952)
Comprehensive loss	(194,182)	(175,771)
Surplus, beginning of year	86,270	262,041
Excess funds distribution (Note 4)	2,611	-
Accumulated (deficit) surplus, end of year	$ (105,301)	$ 86,270

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, 2002 and 2001
(In thousands)

	2002	2001
Cash flows from operating activities:		
Funded earned premiums collected	$ 30,050	$ 29,833
Interest and dividends received, net of related expenses	27,175	35,030
Loss and loss expenses paid	(46,580)	(37,891)
Operating and administrative expenses paid	(1,990)	(2,416)
Net cash provided by operating activities	8,655	24,556
Cash flows from investing activities:		
Sale of investments:		
Common and preferred stocks	429,309	698,947
Bonds	1,648,563	3,476,451
Purchase of investments:		
Common and preferred stocks	(470,385)	(603,792)
Bonds	(1,553,306)	(3,304,644)
Collateral for securities on loan	(47,751)	(38,470)
Restricted cash and cash equivalents	1,720	665
Purchase of equipment	(44)	(100)
Net cash provided by investing activities	8,106	229,057
Cash flows from financing activities:		
Payments on excess funds distribution payable	2,894	(309,821)
Net cash provided by (used in) financing activities	2,894	(309,821)
Change in cash and cash equivalents	19,655	(56,208)
Cash and cash equivalents, beginning of year	253,901	310,109
Cash and cash equivalents, end of year	$ 273,556	$ 253,901

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 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, including political sub-divisions, authorized to self-insure their workers' compensation liabilities in Minnesota are required to be members of the Association.

Retention Limit

For 2002, members selected one of three maximum per loss occurrence retention limits, which were $350,000, $700,000 or $1,400,000. For 2001, members selected one of three maximum per loss occurrence retention limits, which were $330,000, $660,000 or $1,320,000. 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 $7.0 million per occurrence for 2002 ($6.6 million per occurrence for 2001) 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 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 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 Loss

The Association follows the reporting concept of "Comprehensive Loss" which requires the reporting of comprehensive loss in addition to net income from operations. Comprehensive loss 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 loss. Comprehensive loss for the Association includes net loss, unrealized gains and losses (other comprehensive income) on available-for-sale securities, and the impact of foreign currency translation adjustments on securities denominated in a currency other than U.S. dollars.

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.

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

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
Funded earned reinsurance premiums are for the calendar year coverage period for funded losses (losses up to and including the prefunded limit). These premiums are billed in the current period. The reinsurance premiums for the calendar 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.

Unfunded deferred reinsurance premiums are to be billed in future years for unfunded losses (losses in excess of the prefunded limit) incurred during the calendar year coverage period and are recognized as revenue concurrent with the related unfunded losses and loss expenses. These reinsurance premiums 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, 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, 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, 2002 and 2001 is summarized as follows (in thousands):

	2002	**2001**
Funded, undiscounted	$ 3,579,860	$ 3,183,736
Discount	(2,571,712)	(2,263,399)
Funded, discounted	1,008,148	920,337
Unfunded, undiscounted	1,207,178	1,023,174
Discount	(1,121,064)	(948,102)
Unfunded, discounted	86,114	75,072
Total, discounted	$ 1,094,262	$ 995,409

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

	2002	**2001**
Balance, January 1:		
Funded, undiscounted	$ 3,183,736	$ 3,084,814
Incurred related to:		
Current year	175,625	136,301
Prior years	267,079	512
Total incurred	442,704	136,813
Paid related to:		
Current year	291	8
Prior years	46,289	37,883
Total paid	46,580	37,891
Balance, December 31:		
Funded, undiscounted	3,579,860	3,183,736
Discount	(2,571,712)	(2,263,399)
Funded, discounted	$ 1,008,148	$ 920,337

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.

The following table compares the Association's funded reserve changes during 2002 with those of 2001 on a discounted basis (in thousands). Because the reserve discount rate was reduced during 2001 from 8 percent at December 31, 2000, to 7.5 percent at December 31, 2001, this table compares figures in 2002 discounted at 7.5 percent with figures in 2001, most of which are discounted at 8 percent.

Present Value of Funded Reserve Changes	**2002**	**2001**
Funded reserves as of prior year-end (discounted at 7.5% and 8%)	$ 920,337	$ 818,878
Prior year impact of actuarial adjustments (discounted at 7.5% and 8%)	35,121	(273)
Payments on prior accident years (not discounted)	(46,289)	(37,883)
Present value update (calculated at 7.5% and 8%)	67,289	63,995
Reserves for current accident year (discounted at 7.5% and 8%)	31,690	23,838
Change in reserve discount rate from 8% to 7.5%	--	51,782
Total of funded reserve changes during calendar year	87,811	101,459
Funded reserves as of year-end (2002 and 2001 discounted at 7.5%)	$1,008,148	$ 920,337

An update in Minnesota life expectancy assumptions is the primary reason that the prior year impact of actuarial adjustments during 2002 is larger than it was in 2001. This reserve increase of approximately $30 million on prior years reflects the recently released Minnesota data based on the 2000 census. The updated data revealed that Minnesota life expectancy increased 1.3 years between 1990 and 2000. Aside from the life expectancy update, the Association funded reserve levels are relatively stable. In 2002, all other actuarial adjustments on prior accident years, excluding the life expectancy update, increased funded discounted reserves approximately $5 million, an increase of less than 1 percent. The prior year impacts of all funded actuarial adjustments are quantified below.

Prior Year Impact of Funded Actuarial Adjustments in 2002 and 2001	**December 31, 2002 Impact on Funded Discounted (7.5%) Loss and Loss Expense Reserves**	**December 31, 2001 Impact on Funded Discounted (8%) Loss and Loss Expense Reserves**
Annual adjustment of actuarial credibility weights	$ (16,884)	$ (17,007)
Upward loss development	17,533	9,109
Pricing assumption updates	1,474	(373)
Enhanced loss expense methodology	2,873	7,998
Funded prior year impact (life expectancy 1990 census-based)	4,996	$ (273)
2002 update of life expectancy assumptions	30,125	
Funded prior year impact (life expectancy 2000 census-based)	$ 35,121	

The Association 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. This annual adjustment of actuarial credibility weights generally decreases reserves because the amounts actuarially indicated by known claims have been lower than the theoretical amounts. The small upward loss development impacts during 2002 and 2001 have produced a narrower gap between the claims experience and our theoretical assumptions.

In addition to this year's update in life expectancy assumptions, actuarial enhancements similar to 2001 were implemented for 2002 reserves. First, the pricing assumptions used in our reserve analysis were updated. Some of the more significant pricing enhancements done for 2002 include an acceleration of credibility assignments to historical data, a new reserve approach for claims with short-term wage benefits, a medical parameter update and an updated wage distribution.

Second, the funded loss expense methodology for reserves was enhanced again. This year's improvement was the final phase in a multi-year project which produced consistency in the Association's loss expense projections for pricing and reserving.

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

On March 8, 2001, the Board declared an excess funds 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 losses and loss expense reserves, discounted at 8 percent, as calculated in accordance with the Operating Rule for the Determination of Surplus. In 2002, the distribution process was completed. At the conclusion of this process, $2.6 million reverted back to the Association as a result of unclaimed refunds.

5. Cash Flows

A reconciliation of net income to net cash provided by operating activities for the years ended December 31, 2002 and 2001, is as follows (in thousands):

	2002	2001
Net loss	$ (127,653)	$ (124,819)
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized investment losses	46,500	50,449
Decrease (increase) in funded uncollected reinsurance premiums, net of accrued premium adjustments	160	(278)
Increase in liability for funded losses and loss expenses	87,811	101,459
Other, net	1,837	(2,255)
Total adjustments	136,308	149,375
Net cash provided by operating activities	$ 8,655	$ 24,556

6. Investments

The cost of common and preferred stocks, amortized cost of bonds, and estimated fair values at December 31, 2002 and 2001, respectively, are as follows (in thousands):

	2002			
	Cost/ Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Common stocks	$ 542,568	$ 34,837	$ (66,579)	$ 510,826
Preferred stocks	3,424	84	–	3,508
Total stocks	$ 545,992	$ 34,921	$ (66,579)	$ 514,334
U.S. Treasury securities and obligations of U.S. government and agencies	$ 75,035	$ 1,797	$ (376)	$ 76,456
Corporate debt securities	183,027	7,708	(1,575)	189,160
Mortgage backed securities	111,706	3,277	(24)	114,959
Total bonds	$ 369,768	$ 12,782	$ (1,975)	$ 380,575

	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

The amortized cost and estimated fair value of debt securities at December 31, 2002, by contractual maturity, are shown below (in thousands):

	Amortized Cost	**Estimated Fair Value**
Due in one year or less	$ 14,581	$ 14,404
Due after one year through five years	49,152	50,691
Due after five years through ten years	42,769	44,328
Due after ten years	263,266	271,152
Total	$ 369,768	$ 380,575

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 2002, 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 $15.9 million was recorded in earnings as a realized loss. The Association wrote down $8.7 million of individual securities to fair value in 2001.

Other comprehensive loss in 2002 and 2001 is comprised of the change in unrealized gains (losses) on available-for-sale securities arising during the year and the impact of foreign currency translation adjustments on securities denominated in currency other than U.S. dollars as follows (in thousands):

	2002	2001
Change in unrealized losses on securities	$ (77,662)	$ (49,418)
Foreign currency translation gain (loss)	11,133	(1,534)
Total other comprehensive loss	$ (66,529)	$ (50,952)
Unrealized holding losses	$ (113,029)	$ (101,401)
Reclassification adjustment for losses included in net income	46,500	50,449
Net other comprehensive loss	$ (66,529)	$ (50,952)
Accumulatged other comprehensive (loss) income consists of:		
Unrealized losses on securities	$ (27,384)	$ 50,278
Foreign currency translation gain (loss)	6,533	(4,600)
	$ (20,851)	$ 45,678

Gross gains of $127 million and $195 million and gross losses of $174 million and $245 million were realized on sales of investments during 2002 and 2001, respectively. Net investment income and net realized investment gains (losses) during the years ended December 31, 2002 and 2001, are summarized below (in thousands):

	Net Investment Income		Net Realized Gains (Losses)	
	2002	2001	2002	2001
Securities lending	$ 314	$ 336	$ ---	$ ---
Cash and cash equivalents	976	2,852	437	(548)
Common and preferred stocks	8,435	8,383	(53,149)	(61,244)
Bonds	20,121	27,988	6,212	11,343
Miscellaneous	103	189	--	--
	29,949	39,748	$ (46,500)	$ (50,449)
Investment expenses	(4,333)	(4,687)		
	$ 25,616	$ 35,061		

In 2002, net realized losses consisted of losses on securities of approximately $49 million offset by a foreign currency translation gain of $2 million. In 2001, net realized losses consisted of losses on securities of approximately $45 million and a foreign currency translation loss of $5 million.

To enhance the return on investments, the Association maintains a securities lending program. At December 31, 2002 and 2001, the Association had equity and fixed income securities with fair values of $171 million and $218 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 $178 million and $225 million and the related liability representing the collateral received is reflected on the balance sheet at December 31, 2002 and 2001, 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.

7. Subsequent Event

The market for terrorism risk insurance was severely disrupted by the events of September 11, 2001. During this period, the Association continued to cover all workers compensation risks, including those resulting from terrorism. However, many insurers indicated that they would no longer cover terrorism risk or that the cost of limited terrorism coverage would be very expensive. The widespread disruption in the insurance markets had a negative impact on economic activity. To address this situation nationally, the Terrorism Risk Insurance Act of 2002 (TRIA) was signed into law by the President on November 26, 2002. TRIA included special language authorizing the Secretary of the Treasury to include the Association in the Terrorism Insurance Program (Program) created by TRIA. In the event of a certified terrorist act in Minnesota, participation will allow the Association to access Program benefits after the satisfaction of certain deductibles and retentions. In January 2003, Treasury officials preliminarily indicated that the Association will be included in the Program under terms that are expected to be established under regulations to be issued by the Treasury Department during the first half of 2003.

In addition, in February 2003, the Association purchased terrorism reinsurance to cover losses (deductibles and retentions) not covered by TRIA. This terrorism reinsurance contract provides $50 million of coverage in excess of the Association retention of $10 million. This contract is for a three-year term and will cost approximately $2.8 million per year. The reinsurance policy covers acts of domestic terrorism in addition to acts of foreign terrorism covered under TRIA. The policy also provides coverage for nuclear, biological and chemical terrorism acts.

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