
WCRA
25th Anniversary
Annual Report 2004

WCRA

Workers' Compensation Reinsurance Association
Suite 1700, 400 Robert Street North
Saint Paul, MN 55101-2026
651-293-0999
1-800-293-8006
Fax: 651-229-1848
wcra@wcra.biz
www.wcra.biz

A Trusted Partner
Serving Minnesota
Since 1979

To Our Members:

In 2004 the WCRA completed a quarter century of service to our members and the Minnesota workers' compensation system. There have been a number of significant highlights since we opened our doors on October 1, 1979.

- Members have filed more than 17,000 claims with the WCRA.
- Over $500 million in claims reimbursements has been paid.
- Members have paid a total of $1.1 billion in reinsurance premium but received $1.2 billion in surplus distributions.

David Young and Carl Cummins

In 2004, the Association enjoyed a second year of strong financial performance. The investment portfolio earned a 10 percent rate of return for the year, which allowed us to reduce our deficit from $35 million to $10 million. We issued $49 million in reimbursements to members. At year end, the WCRA had $1.15 billion in investments to meet its obligations to pay $1.16 billion in discounted claims.

The Association's total operating expenses of $3.45 million were 2.1 percent under budget. Over the past 10 years, the Association's operating expenses have increased at an annualized rate of only 1.6 percent, reflecting the WCRA's strong commitment to careful management of your premium dollars.

In the past several years, issues concerning the effectiveness of corporate governance and allegations of improper financial management continued to challenge corporate America. In order to assure our members and constituents of the workers' compensation system that the WCRA is being responsibly managed, your Board of Directors focused its attention on evaluating our financial management and controls and the Board's own governance effectiveness.

The Sarbanes-Oxley Act and related changes have had a significant impact on the business environment of corporate America. While Sarbanes-Oxley does not directly apply to the WCRA, the values it establishes should apply to all businesses. In the spirit of Sarbanes-Oxley, we believe that the WCRA should be managed using the highest standards of governance. During 2004 we continued to proactively examine and enhance our governance practices, focusing on best practices relating to our audit committee, internal controls, financial reporting, and independent auditing.

An effective audit committee is one of the cornerstones of corporate governance. In 2004 we reexamined the practices of the WCRA's Audit and Financial Compliance Committee. We compared the practices of that committee to current audit committee best practices as defined by a variety of sources including the Sarbanes-Oxley Act, our independent auditors PricewaterhouseCoopers, the Securities and Exchange Commission, and the New York Stock Exchange. Based on this evaluation, we believe that the charter and practices of the WCRA's Audit and Financial Compliance Committee are comprehensive and consistent with current best practices.

An effective internal control system is a critical responsibility of both corporate management and the board of directors. Consistent with the intent of Sarbanes-Oxley, we performed a review of our system of internal controls using the framework established by the Committee of Sponsoring Organizations of the Treadway Commission. This review focused on the control environment, risk assessment, and the control activities in the major business processes of the WCRA. The control environment sets the tone of our organization and is the foundation of our internal control system. The control environment at the WCRA includes an effective board of directors and advisory committees to the Board, management's conservative operating philosophy, our code of conduct, the integrity and values of staff, and an organizational structure that provides for separation of duties. Our annual review of internal controls concluded with a report to the Audit and Financial Compliance Committee.

The independent audit process provides an evaluation of an organization's financial statements. We believe that this process adds value to the WCRA. Our 2004 independent audit confirmed the quality of our financial statements, and we are proud that your Association again received a clean (unqualified) audit opinion from PricewaterhouseCoopers.

The Board also evaluated its own role in governance of the Association by reviewing the best practices of corporate boards of directors. This analysis indicated that the WCRA Board's policies and procedures have already reflected many of the recognized best practices for corporate boards. In order to further strengthen its governance practices, the Board has established a regular process for evaluating its own performance. In addition, it has put in place a system for identifying prospective Board members who would bring desirable professional qualifications and skills to the Board. The Board acknowledged its collective responsibility for major governance decisions and decided to reduce the role of the Executive Committee. Finally, the Board recognized the important role that the Association's committees play in advising the Board. The WCRA benefits from the expertise of representatives from member organizations who serve on the Investment, Actuarial, Member Services, and Audit and Financial Compliance Committees. The Board concluded that it should strengthen its oversight by adding an additional Board member to the Actuarial Committee and the Audit and Financial Compliance Committee as they make recommendations to the Board on rates, reserving, and a variety of financial matters.

As we enter our second quarter-century of providing reinsurance to the Minnesota workers' compensation system, we believe that these changes have improved both the accountability and transparency of our financial operations and have further strengthened the governance role of your Board of Directors.

MANAGEMENT'S SUMMARY ANALYSIS OF 2004 FINANCIAL RESULTS

Overview

The WCRA experienced continued financial improvement in 2004. The Association recorded comprehensive income of $25 million and further reduced the balance sheet deficit. At December 31, 2004, the balance sheet deficit was $10 million, an improvement of $25 million from the December 31, 2003 deficit of $35 million. This continued financial improvement was primarily due to strong investment returns in the domestic and international investment markets. The investment portfolio returned 10 percent in 2004, 3 percent above the 7 percent investment return assumed in loss reserving.

The Board of Directors has a policy of maintaining a surplus band between -10 percent and +30 percent of the discounted funded loss reserve liability. The December 31, 2004 deficit of $10 million represented -1 percent of funded reserves, an improvement from the -3 percent position at December 31, 2003 and from the -10 percent position at December 31, 2002.

During 2004, the WCRA maintained adequate liquidity and continued to meet all of its financial obligations. For 2004, premiums collected, interest and dividends from investments, loss and loss expenses paid, and operating expenses were all in line with management's expectations.

Operating Results and Comprehensive Income

Premiums and Losses

The WCRA earned $44 million in funded premiums in 2004, up significantly from $32 million in 2003. The increase was primarily the result of a 19 percent increase in the 2004 reinsurance rates and an increase in exposure base. After more than a decade of modest rate increases, a number of factors converged in 2004 that resulted in a significant increase in reinsurance rates. These factors included increases in medical cost trends and reduced investment return projections.

Funded losses and loss expenses incurred for 2004 were $117 million, a decrease of $19 million from the prior year. This decrease was the result of a 2003 change in the reserve discount rate that did not recur in 2004. In 2003, loss reserves were increased by $61 million due to a reduction in the WCRA's long-term earnings assumption and reserve discount rate from 7.5 percent to 7 percent.

There were no actuarial adjustments to loss reserves in 2004 compared with actuarial adjustments that reduced incurred losses by $32 million in 2003. The 2003 actuarial adjustments were primarily due to lowering inflation assumptions and decreasing pricing estimates of losses, which are blended with estimates from claims experience to arrive at needed reserves. The components of funded losses and loss expenses are shown below.

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

	2004	2003
Prior accident years:		
Present value update	$ 75	$ 74
Actuarial adjustments	--	(32)
Reduction in reserve discount rate	--	61
	75	103
Current accident year	42	33
Total funded losses and loss expenses incurred	$ 117	$ 136

Investment Performance

The investment portfolio had a total rate of return of 10 percent in 2004, down from the very strong return of 20 percent in 2003. The 2004 return was primarily due to strong returns in the domestic and international stock markets. Domestic equities returned 12 percent and international equities returned 18 percent. The components of investment results are shown below (in millions).

	2004	2003
Investment income, net of related expenses	$ 25	$ 23
Net realized investment gain (loss)	48	15
Change in unrealized gain (loss) on securities	30	141
Total investment results	$ 103	$ 179

The *WCRA Investment Policy* includes asset allocation targets of 50 percent for domestic equities, 10 percent for international equities, and 40 percent for fixed income investments.

Comprehensive Income

The WCRA recorded comprehensive income of $25 million in 2004, a decline from the strong comprehensive income of $70 million recorded in 2003. Comprehensive income (loss) consists of net income (loss) and the change in unrealized gain (loss) on investments. For 2004, the comprehensive income was primarily due to the strong investment performance. The actual investment return of 10 percent significantly exceeded the 7 percent investment return assumed in loss reserving. In 2003, a very strong investment return of 20 percent exceeded the investment return assumed in loss reserving by 13 percent.

Balance Sheet

Assets and Liabilities

Total assets were $1,600 million at December 31, 2004 compared with $1,513 million at the end of the previous year. The increase in total assets was primarily due to the increase in the market value of the investment portfolio.

Total liabilities were $1,610 million at December 31, 2004 compared with liabilities of $1,548 million at December 31, 2003. The increase in liabilities resulted primarily from an increase in losses and loss expense reserves.

The WCRA's largest liability is the reserve for funded losses and loss expenses. This liability totaled $1,159 million at December 31, 2004 compared with $1,091 million at December 31, 2003. This liability represents the present value, discounted at 7 percent, of the total estimated obligation for losses and loss expenses for unpaid amounts up to the prefunded limit. Because this liability involves claims that will be paid out over a period of many years, judgments as to the ultimate exposure are an important component of the loss reserving process. Reserves are reviewed on a regular basis using a variety of actuarial techniques. They are adjusted based on loss experience and as new information becomes available. Changes in the discounted liability for funded losses and loss expenses are shown below (in millions).

	2004	**2003**
Funded reserves as of January 1	$1,091	$1,008
Losses and loss expenses incurred:		
Prior accident years	75	103
Current accident year	42	33
Total incurred	117	136
Losses and loss expenses paid	(49)	(53)
Funded reserves as of December 31	$1,159	$1,091

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

The liability for unfunded losses and loss expenses totaled $161 million at December 31, 2004 compared with $126 million at December 31, 2003. This liability represents the present value, discounted at 7 percent, of the total estimated obligation for losses and loss expenses for unpaid amounts in excess of the prefunded limit. The $35 million increase in this liability in 2004 was the net result of incurred losses and loss expenses of $36 million offset by loss payments of less than $1 million. The $36 million of incurred losses and loss expenses was due to a combination of prior year actuarial adjustments, reserves for the current accident year, and the present value update. Unfunded deferred premium revenue of $36 million was recognized in 2004 concurrent with the increase in the related unfunded losses and loss expense liability. The WCRA began making loss payments in excess of prefunded limits in 2003. Payments totaled $649,000 and $459,000 in 2004 and 2003, respectively.

Deficit

At year-end 2004, the WCRA had an accumulated deficit of $10 million compared with a deficit of $35 million at the end of 2003. This $25 million improvement resulted from the strong 2004 investment results. The Board of Directors has a policy objective of maintaining a surplus band between -10 percent and +30 percent of the discounted funded loss reserve liability. The December 31, 2004 deficit represented -1 percent of funded reserves, an improvement from the -3 percent position at December 31, 2003 and the -10 percent position at December 31, 2002.

Cash Flow

During 2004, the WCRA maintained adequate liquidity and continued to meet all of its financial obligations. Cash flow from operating activities was $16 million in 2004, a significant improvement from the negative cash flow of $5 million in 2003. This $21 million increase in operating cash flow resulted primarily from an increase in premiums collected and a decrease in losses and loss expense payments. Net realized gains on the sale of investments are not reported as part of net cash provided by operating activities. However, net realized investment gains provide an additional planned source of cash flow to fund the operations of the Association. Net realized investment gains were $48 million in 2004, up significantly from $15 million in 2003.

2004 WCRA Board of Directors

Sitting, L to R: George Klouda (Western National Mutual Insurance Company), David Hennes (The Toro Company), Gary Swoverland (Land O'Lakes), Mark Tansey (Berkley Risk Administrators Company), Wayne Simoneau.

Standing, L to R: Peter Sausen (Department of Finance), Kathryn Lovaas, David Young (Wausau Insurance Companies), Patricia Johnson (State Fund Mutual Insurance Company), Howard Bicker (Minnesota State Board of Investment), Hugh Fendry II (JNR Corporation), Donald Gerdesmeier (Minnesota D.R.I.V.E).

Not pictured: Raymond Waldron (AFL-CIO)

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Suite 1400
225 South Sixth Street
Minneapolis MN 55402
Telephone (612) 596 6000
Facsimile (612) 373 7160

Report of Independent Auditors

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

In our opinion, the accompanying balance sheets and the related statements of operations, comprehensive income and accumulated deficit and cash flows present fairly, in all material respects, the financial position of the Workers' Compensation Reinsurance Association (the "Association") at December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Association's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

February 21, 2005

Workers' Compensation Reinsurance Association
Balance Sheets
December 31, 2004 and 2003

(in thousands of dollars)	2004	2003
Assets		
Investments, at market value		
Cash and cash equivalents (including securities lending collateral of $284,364 and $276,213 at December 31, 2004 and 2003, respectively)	$ 325,181	$ 333,552
Short-term	1,785	62,406
Common and preferred stock	700,768	652,664
Bonds	402,203	319,492
Total investments	1,429,937	1,368,114
Uncollected reinsurance premiums		
Current premiums due	78	44
Deferred funded premiums	2,531	2,553
Deferred for unfunded losses	161,059	125,646
Total uncollected reinsurance premiums	163,668	128,243
Accrued investment income	4,113	3,315
Due from securities brokers	1,764	12,552
Prepaid reinsurance	703	703
Prepaid expenses and other assets	98	251
Property and equipment, less accumulated depreciation of $676 and $582 at December 31, 2004 and 2003, respectively	150	220
Total assets	$ 1,600,433	$ 1,513,398
Liabilities and Accumulated Deficit		
Liabilities		
Losses and loss expenses		
Funded	$ 1,159,143	$ 1,090,970
Unfunded	160,824	125,537
Total losses and loss expenses	1,319,967	1,216,507
Payable under securities loan agreement	284,364	276,213
Due to securities brokers	5,559	55,255
Accounts payable and accrued expenses	234	210
Total liabilities	1,610,124	1,548,185
Accumulated deficit from operations	(159,414)	(154,696)
Accumulated other comprehensive income	149,723	119,909
Designated accumulated deficit (Note 2)	(9,691)	(34,787)
Total liabilities and accumulated deficit	$ 1,600,433	$ 1,513,398

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

Workers' Compensation Reinsurance Association
Statements of Operations, Comprehensive Income and Accumulated Deficit
Years Ended December 31, 2004 and 2003

(in thousands of dollars)	**2004**	**2003**
Revenues		
Reinsurance premiums		
Funded earned	$ 44,230	$ 32,231
Unfunded deferred	35,936	39,882
Ceded reinsurance	(2,812)	(2,812)
Investment income, net of related expenses	24,998	22,604
Net realized investment gain	47,888	14,914
Total revenues	150,240	106,819
Expenses		
Losses and loss expenses		
Funded	117,413	135,768
Unfunded	35,936	39,882
Losses and loss expenses incurred	153,349	175,650
Operating and administrative expenses	1,609	1,551
Total expenses	154,958	177,201
Net loss	(4,718)	(70,382)
Other comprehensive income		
Change in unrealized gains on securities and foreign currency translation adjustment (Note 3)	29,814	140,760
Comprehensive income	25,096	70,378
Accumulated deficit, beginning of year	(34,787)	(105,301)
Recovery of excess funds distribution (Note 6)	-	136
Accumulated deficit, end of year	$ (9,691)	$ (34,787)

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

Workers' Compensation Reinsurance Association
Statements of Cash Flows
Years Ended December 31, 2004 and 2003

(in thousands of dollars)	2004	2003
Cash flows from operating activities		
Net premiums collected	$ 41,929	$ 26,616
Interest and dividends received, net of related expenses	24,799	23,204
Loss and loss expenses paid	(49,889)	(53,405)
Operating and administrative expenses paid	(1,334)	(1,673)
Net cash provided by (used in) operating activities	15,505	(5,258)
Cash flows from investing activities		
Sale of investments		
Short-term, net	60,622	-
Common and preferred stocks	457,053	404,245
Bonds	349,955	1,316,199
Purchase of investments		
Short-term, net	-	(62,406)
Common and preferred stocks	(427,644)	(385,621)
Bonds	(471,986)	(1,305,507)
Collateral for securities on loan	8,152	98,575
Purchase of equipment	(28)	(68)
Net cash (used in) provided by investing activities	(23,876)	65,417
Cash flows from financing activities		
Payments on excess funds distribution payable	-	(163)
Net cash used in financing activities	-	(163)
Net (decrease) increase in cash and cash equivalents	(8,371)	59,996
Cash and cash equivalents		
Beginning of year	333,552	273,556
End of year	$ 325,181	$ 333,552

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

Membership

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

Retention Limits

For 2004, members selected one of three maximum per-loss occurrence retention limits, which were $360,000, $720,000, or $1,440,000. For 2003, members selected one of three maximum per-loss occurrence retention limits, which were $360,000, $720,000, or $1,440,000. Retention limits are determined annually based on a formula prescribed in the Enabling Act. Minnesota workers' compensation losses incurred by members in excess of the retention limit selected are reinsured by the Association.

Premiums

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

- The present value of the estimated ultimate liability for members' incurred losses above the selected retention limit up to and including the prefunded limit of $7.2 million per occurrence for 2004 and 2003 for funded losses reinsured by the Association.

- Loss payments expected to be made to members for claim amounts in excess of prefunded limits (unfunded losses).

- Operating and administrative expenses of the Association, and loss expenses incurred by the Association. (Loss expenses incurred by members on reinsured claims are not recoverable from the Association.)

- Charges for the current year or a prior year, as determined by the Board, for any reinsurance coverage purchased by the Association.

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

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

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

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

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Risks and Uncertainties

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

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

Comprehensive Income

The Association follows the reporting concept of "Comprehensive Income" which requires the reporting of comprehensive income in addition to net income from operations. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of certain financial information that historically has not been recognized in the calculation of net income. Comprehensive income for the Association includes net income, 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.

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

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.

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

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

The Association has entered into interest-rate future, stock index future and interest-rate option contracts. These exchange-traded derivatives are valued at market value and account for less than 1% of total investments.

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

Determination of Surplus
After the close of each fiscal year or at such other times that it deems appropriate, the Board reports whether a surplus or deficit exists based on the annual audited year-end financial statements. In determining whether or not to declare an excess surplus distribution or a deficiency assessment, the Board evaluates surplus or deficit relative to the reserves for discounted funded loss and loss expenses. The Board has determined that up to 30% of funded losses should be retained and reflected on the balance sheet as 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 declared more or less frequently than every five years if the Board, at its sole discretion, determines that it is necessary and prudent to do so. Excess surplus distributions or deficiency assessments may be declared by the Board and distributed to or collected from self-insurer members or policyholders pursuant to the provisions of The Enabling Act and applicable provisions of the Plan.

Reinsurance Premiums

Funded earned reinsurance premiums are for the calendar year coverage period for funded losses (losses up to and including the prefunded limit). These premiums are billed in the current period. The reinsurance premiums for the calendar year may also include a credit or charge to equitably distribute excess or deficient premiums for previous periods, including any excess or deficient premiums resulting from a retroactive change in the prefunded limit. No excess or deficient premiums were distributed or collected in 2004 or 2003.

Effective January 1, 2003, the Association purchased a three-year terrorism reinsurance policy that provides coverage of $50 million excess of a $10 million retention for certain domestic and international terrorist events. This protection is intended to minimize the impact of potential assessments or additional premium charges to Association members by covering terrorism losses not covered by the federal Terrorism Risk Insurance Act of 2002. The annual ceded reinsurance premium for this terrorism reinsurance policy is approximately $2.8 million.

In 2004, the Association began charging annual amounts for the terrorism reinsurance coverage and will continue to do so in calendar years 2005 and 2006. However, the charge relates to each member's exposure for the previous year, thereby matching the period covered by the terrorism reinsurance contract. Therefore, members will be billed for 2004 terrorism coverage during 2005, using their 2004 estimated exposure base. Based on exposure, amounts of $2.5 million and $2.6 million are reflected as earned premium and as deferred funded premium receivable in 2004 and 2003, respectively.

Unfunded deferred reinsurance premiums are to be billed in future years for unfunded losses (loss amounts in excess of the prefunded limit) incurred during the calendar year coverage period and are recognized as earned revenue concurrent with the related unfunded losses and loss expenses. Reinsurance premiums for unfunded losses are billed to the members of the Association in the calendar year when payments in excess of prefunded limits are expected to be reimbursed by the Association. The Association began billing for losses in the unfunded layer in 2003. Premiums of $525,000 and $350,000 were billed in 2004 and 2003, respectively.

Losses and Loss Expenses

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

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

3. Investments

The cost of common and preferred stocks, amortized cost of bonds, and estimated fair values at December 31, 2004 and 2003, are as follows:

	2004			
(in thousands of dollars)	**Cost/ Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Common stocks	$ 553,163	$ 150,400	$ (6,924)	$ 696,639
Preferred stocks	3,868	261	-	4,129
Total stocks	$ 557,031	$ 150,661	$ (6,924)	$ 700,768
U.S. Treasury securities and obligations of U.S. government and agencies	$ 50,027	$ 1,349	$ (372)	$ 51,004
Corporate debt securities	186,144	4,206	(884)	189,466
Mortgage backed securities	160,046	2,347	(660)	161,733
Total bonds	$ 396,217	$ 7,902	$ (1,916)	$ 402,203

	2003			
(in thousands of dollars)	**Cost/ Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Common stocks	$ 536,320	$ 123,183	$ (9,252)	$ 650,251
Preferred stocks	2,305	108	-	2,413
Total stocks	$ 538,625	$ 123,291	$ (9,252)	$ 652,664
U.S. Treasury securities and obligations of U.S. government and agencies	$ 42,755	$ 800	$ (476)	$ 43,079
Corporate debt securities	155,250	5,476	(1,344)	159,382
Mortgage backed securities	115,617	1,543	(129)	117,031
Total bonds	$ 313,622	$ 7,819	$ (1,949)	$ 319,492

Total unrealized losses were $8.8 million and $11.2 million at December 31, 2004 and 2003, respectively. The following tables provide a breakdown of unrealized losses at December 31, 2004 and 2003. The Association has reviewed the components and duration of these unrealized losses and concluded that the losses are temporary in nature. The unrealized losses are primarily on common stocks. The unrealized losses for stock holdings and bond holdings as of December 31, 2004 and 2003, are as follows:

	Unrealized Holding Losses as of December 31, 2004					
	Less than 12 months		12 months or more		Total	
(in thousands of dollars)	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Common stocks	$ 38,988	$ (3,105)	$ 23,056	$ (3,819)	$ 62,044	$ (6,924)
Preferred stocks	-	-	-	-	-	-
Total stocks	$ 38,988	$ (3,105)	$ 23,056	$ (3,819)	$ 62,044	$ (6,924)
U.S. Treasury securities and obligations of U.S. government and agencies	$ 112	$ (373)	$ -	$ -	$ 112	$ (373)
Corporate debt securities	62,247	(501)	10,986	(382)	73,233	(883)
Mortgage backed securities	65,276	(577)	5,661	(83)	70,937	(660)
Total bonds	$ 127,635	$ (1,451)	$ 16,647	$ (465)	$ 144,282	$ (1,916)

	Unrealized Holding Losses as of December 31, 2003					
	Less than 12 months		12 months or more		Total	
(in thousands of dollars)	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Common stocks	$ 36,767	$ (3,932)	$ 50,641	$ (5,320)	$ 87,408	$ (9,252)
Preferred stocks	-	-	-	-	-	-
Total stocks	$ 36,767	$ (3,932)	$ 50,641	$ (5,320)	$ 87,408	$ (9,252)
U.S. Treasury securities and obligations of U.S. government and agencies	$ 13,662	$ (476)	$ -	$ -	$ 13,662	$ (476)
Corporate debt securities	48,345	(1,062)	2,993	(282)	51,338	(1,344)
Mortgage backed securities	32,835	(129)	-	-	32,835	(129)
Total bonds	$ 94,842	$ (1,667)	$ 2,993	$ (282)	$ 97,835	$ (1,949)

The amortized cost and estimated fair value of debt securities at December 31, 2004, by contractual maturity, are shown below:

(in thousands of dollars)	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 8,049	$ 8,034
Due after one year through five years	33,830	34,254
Due after five years through ten years	64,260	66,068
Due after ten years	290,078	293,847
	$ 396,217	$ 402,203

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 2004, the Association made a determination that the decline in the fair value of certain of its investments was other than temporary. As a result of this determination, the cost bases of the individual securities were written down to fair value as the new cost bases, and the total amount of the write-down of approximately $.9 million was recorded in earnings as a realized loss. The Association wrote down $2.8 million of individual securities to fair value in 2003.

Other comprehensive income in 2004 and 2003 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 of dollars)	**2004**	**2003**
Change in net unrealized gains on securities	$ 30,687	$ 131,947
Foreign currency net translation (loss) gain	(873)	8,813
Total other comprehensive income	$ 29,814	$ 140,760

(in thousands of dollars)	**2004**	**2003**
Accumulated other comprehensive income consists of		
Net unrealized gains on securities	$ 135,816	$ 105,129
Foreign currency translation gain	13,907	14,780
	$ 149,723	$ 119,909

Gross gains of $116 million and $98 million, and gross losses of $68 million and $83 million, were realized on sales of investments during 2004 and 2003, respectively. Net investment income and net realized investment gains (losses) during the years ended December 31, 2004 and 2003, are summarized below:

	Net Investment Income		**Net Realized Gains (Losses)**	
(in thousands of dollars)	**2004**	**2003**	**2004**	**2003**
Securities lending	$ 344	$ 369	$ -	$ -
Cash and cash equivalents	937	951	(50)	(11)
Common and preferred stocks	10,399	9,175	49,367	9,210
Bonds	18,138	16,538	(1,429)	5,715
Miscellaneous	173	128	-	-
	29,991	27,161	$ 47,888	$ 14,914
Investment expenses	(4,993)	(4,557)		
	$ 24,998	$ 22,604		

In 2004, net realized gains consisted of gains on securities of approximately $41 million and foreign currency translation gain of $7 million. In 2003, net realized gains consisted of gains on securities of approximately $9 million and foreign currency translation gain of $6 million.

To enhance the return on investments, the Association maintains a securities lending program. At December 31, 2004 and 2003, the Association had equity and fixed income securities with fair values of $277 million and $269 million out on loan, respectively. Cash of at least 102% 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 Association has control over the collateral. An asset of approximately $284 million and $276 million, and the related liability representing the collateral received, are reflected on the balance sheet at December 31, 2004 and 2003, respectively.

4. Liabilities for Losses and Loss Expenses

The liability for losses and loss expenses at December 31, 2004 and 2003, is summarized as follows:

(in thousands of dollars)	2004	2003
Funded, undiscounted	$ 3,845,765	$ 3,602,376
Discount	(2,686,622)	(2,511,406)
Funded, discounted	1,159,143	1,090,970
Unfunded, undiscounted	1,304,899	1,071,778
Discount	(1,144,075)	(946,241)
Unfunded, discounted	160,824	125,537
Total, discounted	$ 1,319,967	$ 1,216,507

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

(in thousands of dollars)	2004	2003
Balance at January 1		
Funded, undiscounted	$ 3,602,376	$ 3,579,860
Incurred related to		
Current year	185,864	159,276
Prior years	106,765	(83,814)
Total incurred	292,629	75,462
Paid related to		
Current year	397	27
Prior years	48,843	52,919
Total paid	49,240	52,946
Balance at December 31		
Funded, undiscounted	3,845,765	3,602,376
Discount	(2,686,622)	(2,511,406)
Funded, discounted	$ 1,159,143	$ 1,090,970

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

The following table compares the present value of the Association's funded reserve changes during 2004 with those of 2003.

	2004	2003
Discount rate at prior year end	7.0%	7.5%
Discount rate at year end	7.0%	7.0%

(in thousands of dollars)	2004	2003
Funded reserves as of prior year end	$ 1,090,970	$ 1,008,148
Prior year impact of actuarial adjustments	(5)	(31,925)
Payments on prior accident years	(48,843)	(52,919)
Present value update	74,638	73,627
Discount rate reduction on prior years	-	61,417
Reserves for current accident year	42,383	32,622
Total calendar year funded reserve changes	68,173	82,822
Funded reserves as of year end	$ 1,159,143	$ 1,090,970

In 2004, there was only a minor prior year impact of actuarial adjustments, as there were no significant changes in loss development or actuarial assumptions. In 2003, the prior year impact of actuarial adjustments was the net result of upward loss development, offset by changes in pricing assumptions, lower inflation/wage assumptions, and the annual update of the actuarial credibility weights used to blend estimates of loss from pricing with those from claims experience.

Unfunded Liabilities

The Association began making payments in excess of prefunded limits in 2003. Payments totaled $649,000 and $459,000 in 2004 and 2003, respectively. Anticipated payments in excess of prefunded limits are billed as premiums for the unfunded layer.

The unfunded reserve methodology follows the funded analysis. Discount rates for unfunded reserves are the same as the funded reserves. The table below compares the present value unfunded reserve changes during 2004 with those of 2003.

(in thousands of dollars)	2004	2003
Unfunded reserves as of prior year end	$ 125,537	$ 86,114
Prior year changes		
Prior year impact of actuarial adjustments	17,158	(24,190)
Payments on prior accident years	(649)	(459)
Present value update	8,765	6,441
Case-versus-theoretical cash flow differences	-	3,035
Change in discount factor methodology	-	35,894
Discount rate reduction on prior years	-	13,352
Reserves for the current accident year	10,013	5,350
Total calendar year unfunded reserve changes	35,287	39,423
Unfunded reserves as of year end	$ 160,824	$ 125,537

In 2004, the prior year impact of actuarial adjustments resulted from changes in loss development estimates and estimates of the timing of future loss and loss expense payments. In 2003, the prior year impact was the net result of changes in loss development estimates, changes in actuarial assumptions, and the annual update of actuarial credibility weights.

In 2003, the assumptions and methodologies used in discounting the unfunded reserve were modified, with significant effect on the unfunded reserve. In 2004, no such changes were made.

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

5. 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. The Association received a tax-exempt determination letter from the Internal Revenue Service dated February 7, 1997. Therefore, no provision for income taxes is included in the Association's financial statements.

6. Recovery of Excess Funds Distribution

On March 8, 2001, the Board declared an excess funds distribution of $310 million, which was equal to the Association's year-end 2000 adjusted surplus, less an amount equal to 32% of discounted funded losses and loss expense reserves. In 2003, $.1 million was reverted back to the Association as a result of unclaimed refunds. In 2004, there was no recovery of excess funds distribution.

7. Cash Flows

A reconciliation of net loss to net cash provided by (used in) operating activities for the years ended December 31, 2004 and 2003, is as follows:

(in thousands of dollars)	2004	2003
Net loss	$ (4,718)	$ (70,382)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Net realized investment gains	(47,888)	(14,914)
(Increase) in funded uncollected reinsurance premiums, net of accrued premium adjustments	(12)	(2,450)
Increase in liability for funded losses and loss expenses	68,173	82,822
Other, net	(50)	(334)
Total adjustments	20,223	65,124
Net cash provided by (used in) operating activities	$ 15,505	$ (5,258)

Net realized gains on the sale of investments are not reported as part of net cash provided by operating activities. However, net realized investment gains provide an additional source of cash flow to fund the operations of the Association.