



Washington State Department of  
**Labor & Industries**

# Industrial Insurance Rainy Day Fund

Engrossed House Bill 2123  
Chapter 37, Laws of 2011

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## Report to the Legislature

February 2012

## Introduction

The 2011 Legislature passed, and Governor Gregoire signed, Engrossed House Bill (EHB) 2123 which significantly reformed Washington's workers' compensation system. This legislation includes several changes designed to improve outcomes for workers and reduce overall system costs for employers. One change, the creation of the Industrial Insurance Rainy Day Fund, is intended to provide a tool to help minimize significant premium rate changes that may otherwise be needed during future difficult economic times.

The language of Section 601, EHB 2123 requires that transfers to the Industrial Insurance Rainy Day Fund be considered whenever the combined assets of the workers' compensation Accident and Medical Aid Funds exceed ten percent of funded liabilities. The law also provides the level of reserves that, when reached, transfers into the Rainy Day Fund are no longer required. The legislation directed that a six-member subcommittee of the Workers' Compensation Advisory Committee (WCAC) recommend whether to change this reserve level.

*EHB 2123, Sec. 601 (3b) Result in total assets of the rainy day fund combined with the assets of the accident and medical aid funds to exceed thirty percent of the accident and medical aid funds' liabilities. (4) The workers' compensation advisory committee shall create a finance subcommittee made up of six members, three of whom shall represent business, and three of whom shall represent workers. The director or director's designee shall chair the committee. The committee shall provide recommendations for any changes to subsection (3)(b) . . .*

## Conclusion

After several meetings and the review of background material and other data, the mandated subcommittee concluded that transfers into the Rainy Day Fund should not be required once the balance of this fund combined with the trust fund reserves reaches 130 percent of the Accident and Medical Aid Funds' stated liabilities. Said another way, transfers would stop once the Rainy Day Fund combined with the department's Accident and Medical Aid Fund contingency reserves reach thirty percent of liabilities. The contingency reserve is the difference between the funds' assets and liabilities.

The subcommittee's recommendation is to keep the cap currently provided in EHB 2123. The subcommittee's work and other recommendations are provided further in this report.

## Subcommittee Membership

The WCAC appointed the following members to the Rainy Day Fund subcommittee. We thank these individuals for the hours they committed to several meetings and to reviewing historical financial material and information.

Rainy Day Fund Committee	
Representing Business	Representing Labor
Linda Maw <i>True Blue</i>	Diane Zahn <i>United Food and Commercial Workers (UFCW) 21</i>
Rick Slunaker <i>Associated General Contractors</i>	Larry Brown* <i>International Association of Machinists</i>
Teran Petrina <i>Washington Restaurant Association</i>	Rebecca Johnson <i>Washington State Labor Council, AFL-CIO</i>
	Nicole Grant (Alternate)* <i>Certified Electrical Workers of Washington</i>

\*Although appointed to the subcommittee, Larry Brown was not able to participate in the meetings.

### Subcommittee Meetings

The subcommittee met five times before reaching their conclusion described above. In addition to the business and labor representatives, the meetings were facilitated and informed by the following L&I staff:

- Judy Schurke, Director
- Beth Dupre, Assistant Director for Insurance Services
- Vickie Kennedy, Chief Policy Advisor
- Bill Vasek, Senior Actuary
- Russell Frank, Actuary

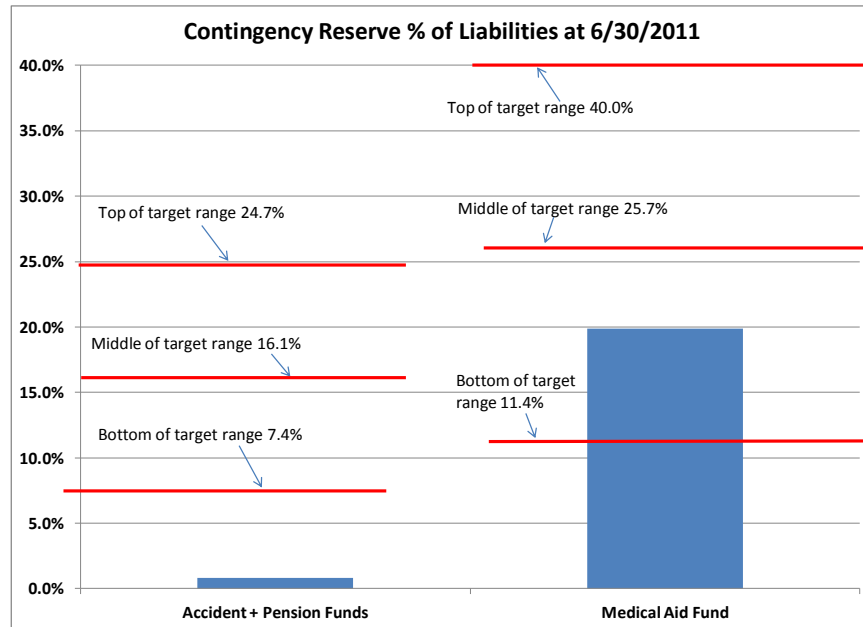
Scott Daniels, Managing Director of Conning Research and Consulting, LLC, provided consultation in person or by phone. Conning Research is a nationally recognized firm offering insurance industry research, forecasts and models based on analysis of industry performance information. Conning also consulted with the prior WCAC finance committee discussed below, and contracts with the Washington State Investment Board to provide research specific to the workers’ compensation insurance industry. Their peer review information and comparisons of L&I's contingency reserves and financials to other state funds and large private sector workers' compensation insurers was provided to the subcommittee for their discussions and consideration.

### Meeting Topics and Discussion

In preparation for the first meeting, subcommittee members were asked to familiarize themselves with the summary of work done by a prior WCAC finance subcommittee that met over approximately 18 months. The prior finance committee spent several meetings discussing issues related to financial stability including peer comparisons, equity investment allocations, short- and long-term implications of contingency reserve levels, and how various factors relate to chances of actuarial insolvency. They then considered various options for reserve level policies, and developed draft recommendations for contingency reserve levels by fund. As described in the summary of their work, these recommendations are based on the proportion of funds invested in equities and should be revisited if equity levels are changed significantly.

The finance committee recommendations were made in 2007, just before the Great Recession significantly impacted liabilities and fund reserves. The committee's recommendation summary is attached as Appendix A.

The table on the next page reflects the draft policy levels by fund based on the finance committee's recommendations, and the contingency reserve balances as of June 30, 2011.



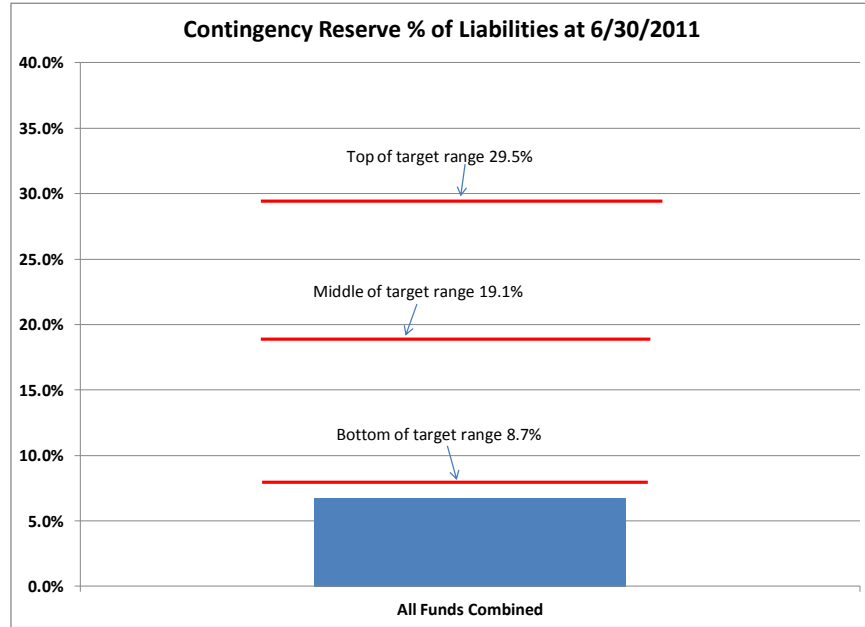
Terms used in the table are defined below:

*The Accident Fund pays partial wage replacement, permanent disability benefits, and pensions for totally disabled workers and survivors of fatally injured workers, along with vocational retraining costs such as tuition and books. Only employers contribute to this fund. The Pension Reserve Fund is a sub-account of the Accident Fund and provides pension payments.*

*The Medical Aid Fund pays for health care and private vocational services for injured workers. Employers and workers contribute equally to this fund.*

*The contingency reserve is the difference between the assets of the fund or funds and the estimated lifetime liabilities of current claims.*

The next table shows the bottom, middle, and top target range for the combined accident, pension reserve, and medical aid funds. Note that the bottom and top targets (8.7 and 29.5 percent respectively) are relatively similar to the level mandated in EHB 2123 at which transfers into the Industrial Insurance Rainy Day Fund should occur (contingency reserve at ten percent of liabilities), and when transfers are no longer required (combined Rainy Day Fund and contingency reserve at 30 percent of liabilities). The blue bar provides the combined Accident and Medical Aid Fund contingency reserves as of June 30, 2011.



The initial subcommittee meeting included a peer review report by Scott Daniels. This report, attached as Appendix B, shows that the current contingency reserves for Washington's workers' compensation trust funds are well below those of private insurers and of other state funds. For the quarter ending June 30, 2011, Washington's contingency reserve was less than one-twentieth of other state funds.

In addition to the material reviewed in their initial discussion, subcommittee meetings included review and discussion of the worker's compensation asset and liability history, various scenarios showing how the contingency reserves and Rainy Day Fund would interact over time, and details of the Conning peer analysis.

### Basis for Conclusion

The subcommittee acknowledged several points:

- The legislated cap when transfers to the Rainy Day Fund are no longer required is very similar to the high point of the draft policy level for the combined Accident and Medical Aid Fund contingency reserves.
- The timing of the Great Recession did not allow for the draft policy levels to be adequately tested or evaluated.
- The legislated cap compares reasonably to surpluses of other state funds.

Given these points, the group concluded with one dissenting vote that the cap established in EHB 2123 was appropriate based on information currently available.

### Minority Report

Rick Slunaker, one of the three business representatives on the subcommittee, did not agree with the majority opinion. Separately, he may provide a minority report articulating his opinion and basis for it.

### **L&I's Recommendation for Language Clarification**

L&I consulted with the Office of the Attorney General advisor concerning the language of Section 601 of EHB 2123 and whether additional statutory changes were necessary for the department to administer the provisions of the new law. Although the AGO's opinion was that statutory change was not necessary, Appendix C provides possible language should the legislature want to pursue amendments in 2012. The draft language addresses the following issues:

- Insurance accounting standards changed in 2010 regarding securities lending transactions. L&I incorporated this new accounting requirement in the 2011 statutory reporting to include collateral held and obligations under securities lending agreements. This means that the trust fund assets and liabilities that are stated in statutory financial reports are higher amounts than in the past. The higher amount stated in liabilities is offset by higher stated assets. The law should be amended based on this new reporting requirement to avoid higher balances in the Rainy Day Fund than necessary.
- The Pension Reserve Fund is administered as part of the Accident Fund, but is listed separately in the law. This fund should be added to the language to clarify that its assets and liabilities are included in the director's consideration of whether to transfer funds to the Rainy Day Fund.
- Other changes are offered to improve clarity.

Based on the input of the AGO, L&I is not pursuing these changes as executive request legislation in 2012.

**(Draft)**  
**Washington State Fund**  
**Contingency Reserve**  
**Policy Range**

**Bill Vasek, FCAS, PhD**  
**Senior Actuary**

**Actuarial Services**  
**Department of Labor and Industries**

**February 21, 2007**

## **(Draft) Washington State Fund Contingency Reserve Policy Range**

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**Acknowledgements**



## **(Draft) Washington State Fund Contingency Reserve Policy Range**

### **Executive Summary:**

Beginning in 2007, Engrossed House Bill 1917 that became law in 2005, engages the Workers' Compensation Advisory Committee (WCAC) to recommend Contingency Reserve limits together with corresponding premium funding actions in order to

- a) maintain actuarial solvency of the accident and medical aid funds,
- b) limit premium rate fluctuations, and
- c) account for economic conditions.

After discussions with members of the WCAC, the Workers' Compensation Finance Committee, State Investment Board staff, and others listed in the Acknowledgments, the following Contingency Reserve policy for setting premium rates is given in order to meet these three goals:

The premium rates shall be maintained at the actuarial indicated "break-even" rate levels, which helps lead to actuarial solvency and rate stability and is in accordance with generally accepted actuarial principles. However, when the following financial conditions occur, the following premium funding decision shall be made, unless economic conditions are deemed to make such actions an unreasonable burden on the business and labor communities:

- 1) The Contingency Reserve policy ranges for each fund need to be kept financially consistent with the stated actuarial solvency standard, the expected chance of going outside the policy range, the stated equity asset allocation, and the observed volatility of the liabilities of the funds by doing periodic dynamic financial analysis of this policy.
- 2) When the Contingency Reserve of any fund is above the policy range's upper bound, reduce the funding in that fund, using either dividends to employers, premium rate holidays, or premium rate reductions with the expectation of decreasing the Contingency Reserve of the affected fund to the middle of the policy range within the next rating year.
- 3) When the Contingency Reserve of any fund is below the policy range's lower bound, increase the funding by instituting a premium load of no more than 10% above the "break-even" rate level for actuarial indications in the affected fund, with the expectation to get the Contingency Reserve back to the middle of the policy range within a five-year period.

The following Contingency Reserve policy ranges are established in each fund as a percentage of liabilities (June 30, 2006 liabilities used just for descriptive purposes) consistent with a ten percent equity asset allocation in

the accident fund and pension funds combined, and fifteen percent in the medical aid fund:

<u>Fund:</u>	<u>Lower</u>	<u>Midrange</u>	<u>Upper</u>
Accident + Pension	6.9%	15.6%	24.2%
	\$ 415 M	\$ 933 M	\$ 1,450 M
Medical Aid	11.4%	25.7%	40.0%
	\$ 336 M	\$ 759 M	\$ 1,182 M

The ranges are separate ranges per fund and are not considered in aggregate. However, the expectation is to be near the midrange of both policy ranges, which turns out to be 18.9% of liabilities, which would have been \$1,692 M.

The policy ranges were designed based on the following assumptions and chosen risk tolerance standards:

**Actuarial Solvency Standard:** Chance of a Contingency Reserve deficit at the end of a three-year period is 1%.

**Rate Stability Standard:** Starting at the middle of the policy range while rates are set at the indicated break-even level, the chances of the following events at the end of a three-year period are as follows:

Premium surcharge: 10%.

Funding reduction : 10%.

Premiums at break-even level: 80%

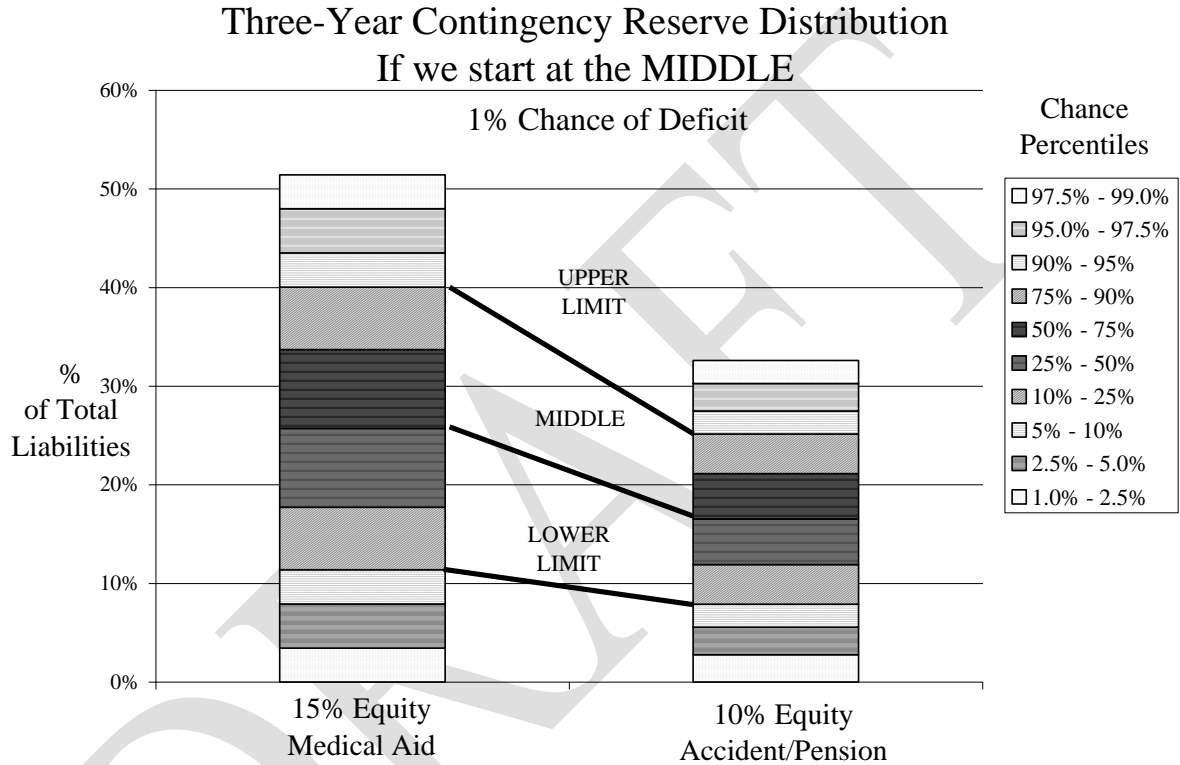
**Equity Asset Allocation:** Middle of the policy equity allocation for invested assets in the combined Accident and Pension funds is 10% and 15% for the Medical Aid fund. The lower and upper bounds of the policy range are 20% from the middle. When equity percentages veer outside the range, then equities are either bought or sold to get back to the middle of the policy range. (Note: the middle of the equity allocation policy range assumption differs from the current policy values of 30% in the medical aid.)

**Observed Liability Volatility:** Variability in loss ratios (at current benefit and premium rate levels) between accident years, as measured by the standard deviation is 15% for both the combined Accident and Pension funds and the Medical Aid fund. Also other observed liability characteristics.

**Consistency:** All of these standards and measures need to be modeled in an internally consistent manner, taking into consideration any interactions.

The following chart describes the dynamic financial analysis work done by Conning and Company on the chance variability of the Contingency Reserve within a three-year period as shown by the following percentiles chart. The percentiles give the points where the chance that the State Fund Contingency Reserve be at least as great as the given chance figure at the end of a three-year period when the Contingency Reserve starts in the middle of the range. The 1st percentile is at zero, so that there is a 1% chance that the Contingency Reserve will end up below zero in this three-year period as stated in our

actuarial solvency standard. The lower limits are at the 10th percentile which means that there is a 10% chance that the Contingency Reserve will be less than this lower limit in this period. The upper limits are at the 90<sup>th</sup> percentile which means that there is a 10% chance that the Contingency Reserve will be greater than this limit in this three-year period. This 90<sup>th</sup> percentile upper limit is also known as the 90% level “Value at Risk” or VaR using a three-year period.





## Peer Analysis Introduction

- ❖ Compare L&I to other state funds and to private insurers as of year end 2010
  - ❖ 18 of the 24 state workers' compensation funds
  - ❖ 14 private insurers that write large dollar amounts of workers' compensation
- ❖ Sources are OneSource's Highline Data, A.M. Best and company financial statements
- ❖ Peer analyses are used by equity analysts, rating agencies and state insurance departments
- ❖ Key points:
  - ❖ L&I is the 5<sup>th</sup> largest writer of workers' compensation insurance in the U.S.
  - ❖ L&I discounts its loss reserves, adding \$8 billion of contingency reserve. Private insurance companies and most state funds do not discount loss reserves. Colorado, New York and Ohio state funds also discount their loss reserves. Discounting presents a truer economic picture, but makes direct comparison to peers difficult.
  - ❖ Even with the loss reserve discount, L&I has a small contingency reserve, compared to the size of its operations and to other insurance entities.
  - ❖ For example, leverage ratios compare premiums and loss reserves to the size of the contingency reserve; these are rough measures of contingency reserve adequacy.
    - Premium to surplus ratios rarely exceed 1 to 1. L&I needs a \$1.3 billion contingency reserve to achieve this ratio.
    - Loss reserve to surplus ratios average about 2 to 1. L&I needs \$22 billion (using discounted loss reserves )to \$38 billion (using undiscounted loss reserves) to achieve this ratio.



### State Funds

Beacon Mutual (RI)  
 CompSource Oklahoma  
 Hawaii Employers Mutual  
 Idaho State Insurance Fund  
 Kentucky Employers Mutual  
 Louisiana Workers Comp  
 Maine Employers Mutual  
 Missouri Employers Mutual  
 New Mexico Mutual Casualty  
 New York State Insurance Fund  
 Ohio Bureau of Workers Compensation  
 Pinnacle Assurance (CO)  
 SAIF (OR)  
 SCF Arizona  
 State Fund (CA)  
 State Fund Mutual Minnesota  
 Texas Mutual Insurance  
 Workers Comp Fund Utah

### Private Insurers

Accident Fund Insurance  
 ACE American Insurance Group  
 American Home Assurance (AIG)  
 Amerisure Mutual Insurance  
 Argonaut Insurance Group  
 Continental Casualty Group  
 Employers Ins Co of NV  
 FCCI Mutual Insurance Group  
 Hartford Casualty Insurance  
 Liberty Mutual Group  
 National Union Fire of Pittsburgh (AIG)  
 Travelers Casualty & Surety  
 WR Berkley Group  
 Zurich Insurance Group

- ❖ We did not have data for the Maryland, Montana, North Dakota, Pennsylvania, South Carolina or Wyoming state funds.
- ❖ The private insurers include both workers' compensation specialists such as The Accident Fund Insurance Company, and large multi-line companies such as the Travelers.



## Peer Overview

### Financial Summary, Year End 2010

(\$s in 000s)	Direct	Net Written	Invested	Statutory	Loss & LAE
	Written Premium	Premium	Assets	Surplus	Reserves
Labor & Industries (WA)	1,318,507	1,318,507	11,112,539	181,210	11,223,311
State Fund Average	366,043	364,371	4,025,315	1,038,208	3,153,398
Private Insurer Average	4,753,756	3,958,681	14,070,086	5,115,466	8,843,379
Peers Combined Simple Average	2,559,900	2,161,526	9,047,700	3,076,837	5,998,388

Source: Highline Data, company financial statements

- ❖ L&I is significantly larger than the state fund average:
  - ❖ Premiums are 3.6x the average
  - ❖ Investments are 2.8x
  - ❖ Reserves are 3.5x
  - ❖ Surplus at 0.2x is the exception
- ❖ L&I is roughly comparable to the private insurer averages, except for surplus



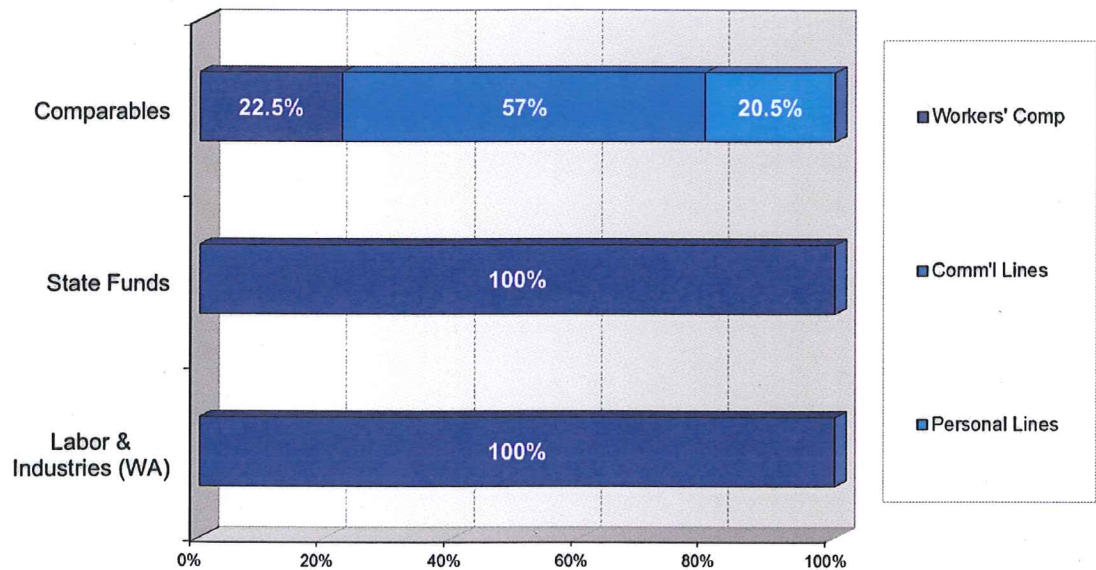
# Mix of Business

2010 Net Written Premium Distribution

Companies	Workers' Comp	Other Liability	CMP	Other Comm'l Lines	Personal Auto	HO/FO	Other Lines	Total
Labor & Industries (WA)	100%	0%	0%	0%	0%	0%	0%	100%
State Funds	100%	0%	0%	0%	0%	0%	0%	100%
Private Insurers	22%	22%	11%	11%	11%	9%	14%	100%
All Peers Average	32%	19%	9%	10%	10%	8%	12%	100%

Source: Highline Data, company financial statements

- ❖ The state funds including L&I wrote \$7.9 billion of workers' comp premiums, and the private insurers wrote \$10.7 billion
- ❖ Conning Research & Consulting (CRC) estimates total 2010 premiums of \$33 billion; adding Washington and Ohio increases this to \$36 billion (3<sup>rd</sup> Quarter 2011 *Forecast & Analysis*)
- ❖ This peer analysis encompasses about 50% of total workers' comp premiums



Source: Highline Data, company financial statements

# Insurance Results

Insurance Results								
Companies	Loss Ratio	LAE Ratio	Expense Ratio	PH Div. Ratio	Combined Ratio	Inv. Inc. Ratio	Operating Ratio	ROS
Labor & Industries (WA)	162%	12%	6%	0.0%	179%	37%	142%	-147%
State Funds	97%	23%	22%	7.8%	149%	65%	86%	13%
Private Insurers	64%	16%	29%	0.2%	109%	17%	93%	5%
All Peers Combined Weighted Average	68%	16%	28%	1.0%	114%	22%	92%	7%

Source: Highline Data, company financial statements

- ◆ Loss Ratio is benefit expense per premium dollar
- ◆ Loss Adjustment Expense Ratio is claim administration expenses (e.g., legal fees) per premium dollar
- ◆ Expense Ratio is other administration expenses per premium dollar
- ◆ Policyholder Dividends Ratio is PH dividends per premium dollar
- ◆ Combined Ratio is the sum of loss, expense and dividend ratios; over 100% means you lost money on insurance operations. Workers' comp insurers often have combined ratios over 100%.
- ◆ Investment Income Ratio is investment income (bond coupons and stock dividends) per premium dollar
- ◆ Operating Ratio is the Combined Ratio minus investment income; over 100 means you lost money even after investment income. Operating ratios over 100% are a potentially serious problem.
- ◆ Return on surplus is profit per dollar of surplus; CRC estimates workers' compensation ROS will average 6% for the 10 years 2004-2013 (3<sup>rd</sup> Quarter 2011 *Forecast & Analysis*)

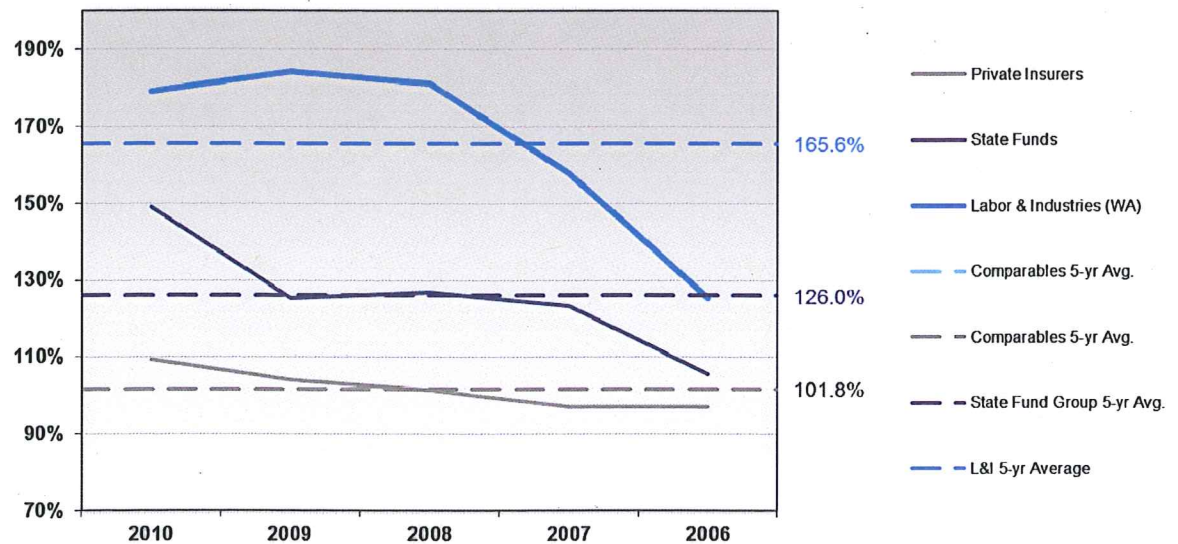


# Combined Ratio

Companies	Combined Ratio					
	2010	2009	2008	2007	2006	Avg.
Labor & Industries (WA)	179%	184%	181%	158%	125%	166%
State Funds	149%	125%	127%	123%	106%	126%
Private Insurers	109%	104%	102%	97%	97%	102%
All Peers Combined Weighted Average	114%	107%	104%	100%	98%	105%

Source: Highline Data, company financial statements

- Combined ratios have generally gotten worse since 2006, due to increasing costs. 2006 was the rare year where the workers' comp industry made money on insurance operations, with a combined ratio of 96%.



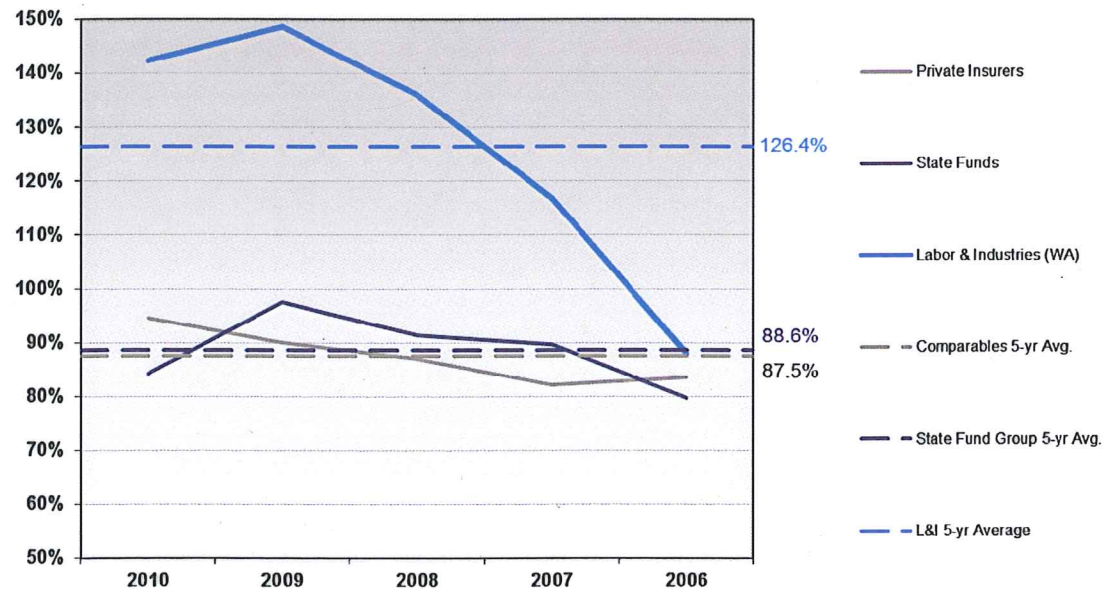
Source: Highline Data, company financial statements

# Operating Ratio

Companies	Operating Ratio					
	2010	2009	2008	2007	2006	Avg.
Labor & Industries (WA)	142%	149%	136%	117%	88%	126%
State Funds	84%	98%	91%	90%	80%	89%
Private Insurers	95%	90%	87%	82%	84%	88%
All Peers Combined Weighted Average	94%	91%	88%	83%	83%	88%

Source: Highline Data, company financial statements

- ❖ Losing money after including investment income (an operating ratio over 100%) is unusual
- ❖ Over 5 years the state funds and the private insurers have similar operating ratios. Profits before taxes averaged about 12 cents per premium dollar
- ❖ L&I has lost money on recurring operations since 2007



Source: Highline Data, company financial statements

## Surplus Adequacy

### Measures of Surplus Strength, 2010

Companies	Surplus Leverage			RBC Ratio	BCAR	Best's Rating	Invest. Leverage	
	Premium	Reserve	Total				Surplus	Premium
Labor & Industries (WA)	7.3	61.9	69.2	NM	NM	NR-5	61.3	8.4
State Funds Weighted Average	0.4	3.0	3.4	1138%	415	A	3.5	10.0
Private Insurers	0.8	1.7	2.5	497%	202	A	2.7	3.5
All Peers Combined Weighted Average	0.7	2.0	2.7	530%	246	A	2.9	4.2

Source: A.M. Best, Highline Data and company financial statements

- ◆ Having enough surplus is critical for insurers, so there are many ways to measure surplus adequacy
- ◆ Premium and reserve to surplus ratios are rough measures of risk exposure
- ◆ Risk-based Capital (RBC) calculates how much capital an insurer needs based on the specific risks it takes, and then compares actual capital to this required capital. Ratios of 200% or less are a problem. L&I (and NY and Ohio) does not calculate an RBC ratio.
- ◆ BCAR, or Best Capital Adequacy Ratio, is similar to RBC. It is part of A.M. Best's determination of an insurers rating. Most workers' compensation insurers need at least an A- rating to be competitive.
- ◆ Investment to surplus ratio measures potential exposure to capital market crises. How an insurer invests is also critical, because of investment accounting rules.
- ◆ Investment to premium ratio is not a measure of capital adequacy. It is useful when comparing investment income ratios.



## Insurance Leverage Ratios

Companies	Insurance Leverage					Avg.
	2010	2009	2008	2007	2006	
Labor & Industries (WA)	69.2	21.9	6.8	5.0	5.9	21.8
State Funds	3.4	3.9	4.3	4.1	3.7	3.2
Private Insurers	2.5	2.6	3.0	2.6	2.9	2.5
All Peers Combined Weighted Average	2.7	2.8	3.3	2.9	3.0	3.0

*Table corrected 10/31/11*

Source: Highline Data, company financial statements

- ◆ Insurance leverage is the sum of the premium-to-surplus ratio and the reserves-to-surplus ratio. Premiums and loss reserves are the two biggest sources of risk for insurers, so these ratios are rough measures of surplus adequacy.
- ◆ Over the last 5 years premiums and losses have generally fallen. Excluding the 2008 financial crisis, surplus has generally risen. The property-casualty industry is well capitalized.
- ◆ L&I's recent leverage ratios would not be allowed in a private insurer. State regulators would have stepped in.


**Investment Strategy**
**Invested Asset Allocation**

<b>Companies</b>	<b>Cash</b>	<b>A-AAA Bonds</b>	<b>BBB Bonds</b>	<b>High Yield</b>	<b>Common Stock</b>	<b>Schedule BA</b>	<b>Other *</b>
<b>Labor &amp; Industries (WA)</b>	2%	67%	19%	1%	11%	0%	0%
<b>State Funds</b>	2%	75%	7%	1%	13%	0%	1%
<b>Private Insurers</b>	0%	69%	10%	4%	4%	10%	2%
<b>All Peers</b>	1%	71%	9%	3%	6%	7%	2%

Source: Highline Data, company financial statements

\* *Hybrid Securities, Preferred Stock, Collateral & Mortgage Loans, Occupied and Investment Real Estate*

- ❖ Investment grade bonds receive favorable amortized cost accounting treatment, so insurers generally have large allocations
- ❖ L&I owns more BBB-rated bonds than the peer groups; the extra income helps support premium rates. BBB-rated bonds still receive favorable accounting treatment.
- ❖ 'Schedule BA' is the page in the regulatory financial statements where insurers record hedge funds, private equity, limited partnerships and other alternative assets



## Investment Exposures

### Market Valued Assets as a % of Surplus

	Pref'd	Common	High Yield	Other (Sch BA)	Total
Labor & Industries (WA)	0%	731%	41%	0%	772%
State Funds	0%	49%	3%	1%	54%
Private Insurers	2%	11%	12%	27%	52%
All Peers Combined	1%	19%	10%	22%	53%

Source: Highline Data, company financial statements

- ❖ Investments that do not receive favorable accounting treatment are stocks, high yield bonds and alternative investments
- ❖ These are valued at either market value or lower-of-cost-or-market, which means changes in their value can affect surplus