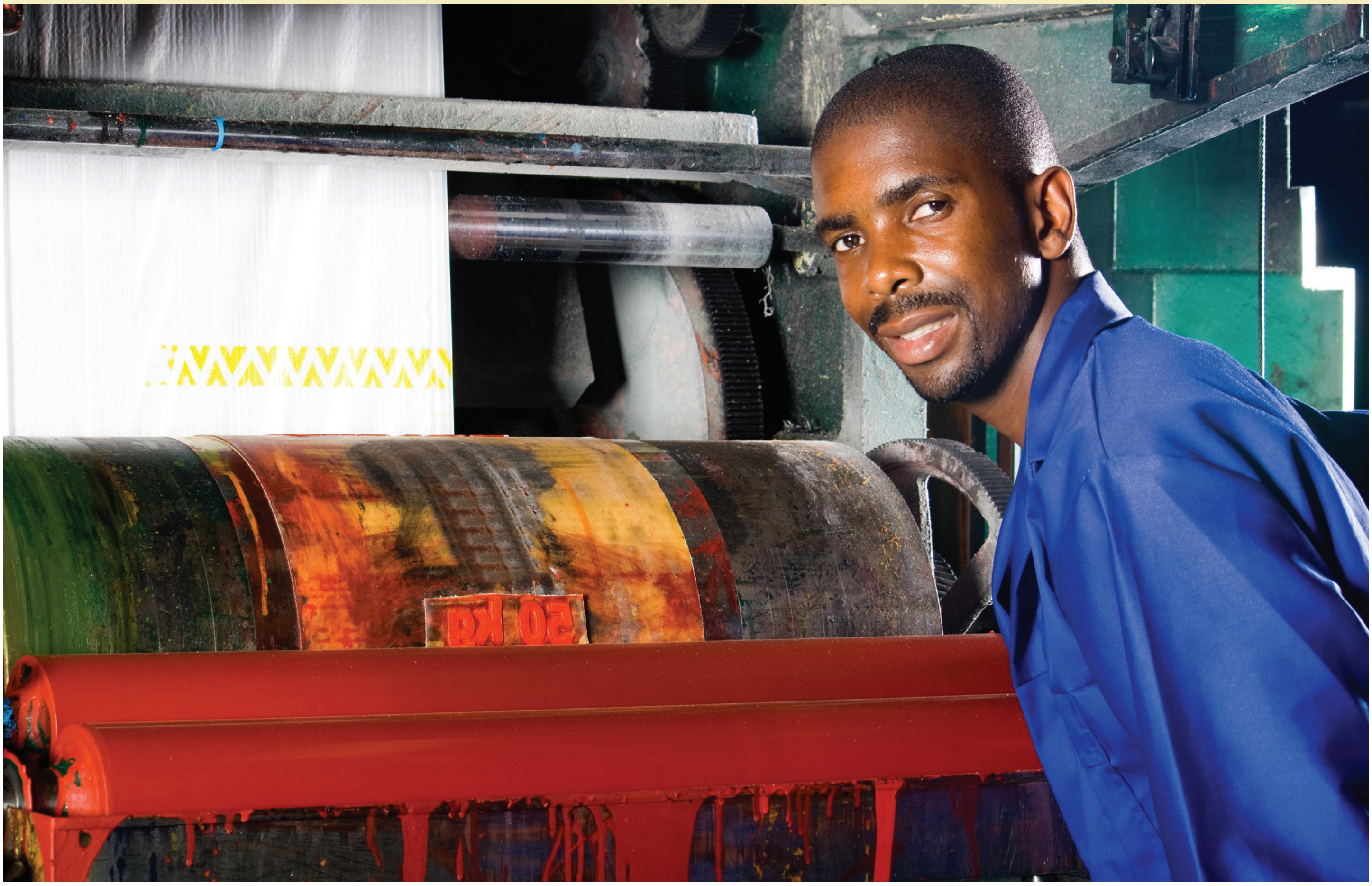
Washington State Department of
Labor & Industries

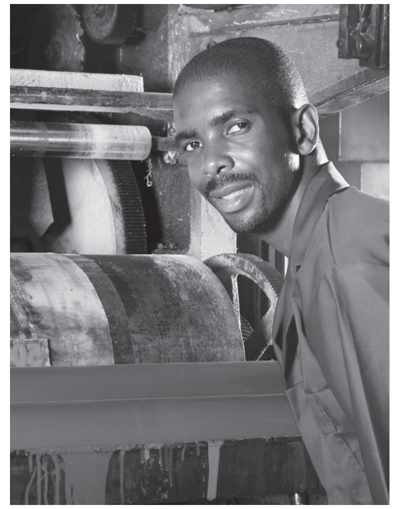


# State of Washington Industrial Insurance Fund Statutory Financial Information Report

*For the Fiscal Years Ended June 30, 2016 and 2015*



***State of Washington Industrial Insurance Fund***
***Statutory Financial Information Report***
For the Fiscal Years Ended June 30, 2016 and 2015



*Prepared by:*

**Department of Labor and Industries**
Joel Sacks, Director
Ernie LaPalm, Deputy Director
Randi Warick, Deputy Director for Financial Management

**Actuarial Services**
Bill Vasek, FCAS, Senior Actuary
Mark Mercier, ACAS, MAAA
Joshua Ligosky, FCAS, MAAA

**Administrative Services**
David Marty, Assistant Director

**Financial Services**
Sharon Elias, Chief Accounting Officer
Rob Cotton, MBA, CPA, CMA, CGAP, Workers' Compensation Accounting Manager
Margo Driver, CPA, Revenue Accounting Manager
Linda Tilson, Accounting Services Manager
Teena Minning, Workers' Compensation Accountant
Cathy Mowlds, Workers' Compensation Accountant
Mariya Rohde, Workers' Compensation Accountant
Yvonne Quijano, Workers' Compensation Accountant
Financial Services Program Personnel

**Insurance Services Division Personnel**

**Additional assistance provided by:**
Washington State Office of Financial Management
Washington State Investment Board

Washington State Department of
Labor & Industries

*Keep Washington Safe and Working*

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# Introductory Section

Washington State Department of
Labor & Industries

***Keep Washington Safe and Working***

STATE OF WASHINGTON

DEPARTMENT OF LABOR AND INDUSTRIES

P.O. Box 44000 • Olympia Washington 98504-4000

December 9, 2016

The Honorable Jay Inslee, Governor
Honorable Members of the Legislature
Director of Office of Financial Management
Washington State Citizens
Olympia, Washington 98504

***RE: Statutory Financial Information Report***

The Revised Code of Washington 51.44.115 requires the Department of Labor and Industries (L&I) to publish a Statutory Financial Information Report for the Industrial Insurance Fund (State Fund) in conformity with statutory accounting practices and principles promulgated by the National Association of Insurance Commissioners within six months of the close of each fiscal year. This report is published to fulfill that requirement for the fiscal year ended June 30, 2016.

L&I is fully responsible for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal controls established for this purpose. Because the cost of internal controls should not exceed anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements.

The independent certified public accounting firm, Eide Bailly, LLP, has issued an unmodified ("clean") opinion on the Statutory Financial Information Report for the fiscal years ended June 30, 2016 and 2015. The independent auditor's report is located at the front of the financial section of this report.

Management's Discussion and Analysis (MD&A) immediately follows the independent auditor's report and provides a narrative introduction, overview, and analysis of the Consolidated Statutory Financial Statements. The MD&A complements the information provided in this letter of transmittal and should be read together with it.

## *PROFILE OF THE INDUSTRIAL INSURANCE FUND*

The Industrial Insurance Fund is part of the Workers' Compensation Program and is made up of the Accident, Medical Aid, and Pension Reserve Accounts. The activities within the Industrial Insurance Fund are financed and operated in a manner similar to private business entities. Premiums collected from employers and workers and investment earnings finance the cost of providing medical coverage, time-loss payments, disability benefits, Stay at Work reimbursements, and structured settlements. L&I prepares a Statutory Financial Information Report for the Washington State Industrial Insurance Fund of the Workers' Compensation Program annually, based on a fiscal year beginning July 1 and ended June 30.

L&I, an agency of Washington State, is responsible for managing the state's workers' compensation system; enforcing the Washington Industrial Safety and Health Act; providing safety and health consultations and information; enforcing wage and hour, child labor and family leave requirements; managing the state's Crime Victims' Compensation Program; registering contractors and apprentices; inspecting electrical work, elevators, boilers and factory-assembled structures; and issuing licenses for certain skilled trades.

L&I headquarters is located at 7273 Linderson Way SW in Tumwater, Washington. There are 18 additional L&I field offices across Washington State that enable us to respond to specific needs in different localities.

The workers' compensation system has existed in Washington State for 105 years. Washington was one of the first states to enact workers' compensation laws. Our state's Workmen's Compensation Act, established on July 28, 1911, was designed to protect workers and employers from injustice and financial hardship arising from work-related injuries in extremely hazardous work. In 1923, Washington became one of only two states where workers pay a portion of the insurance premiums.

Washington's workers' compensation insurance was provided solely through the State Fund until 1971, when the Legislature expanded the scope of coverage to virtually all workers and created an option for qualified employers to self-insure. The Self-Insurance Program allows employers with sufficient financial resources to pay the cost of claims for their injured workers from their own funds and assume significant responsibility for their own claims administration. The workers of self-insured employers are entitled to the same rights and benefits as those workers insured by the State Fund managed by L&I. There are approximately 355 employers who are self-insured, covering close to one-quarter of all workers in Washington.

The State Fund has an optional financial incentive program, called Retrospective Rating, to help qualifying employers reduce their industrial insurance costs through safety and return-to-work efforts. Employers who join the Retrospective Rating Program receive partial refunds if their claim costs are lower than expected, but must pay additional premiums if their claim costs are higher than expected.

The Industrial Insurance Fund covers approximately 177,000 employers and 2.8 million workers statewide. Total premiums assessed during fiscal year 2016, including both the employer and worker portions, were $2.12 billion. Over 95,000 claims were accepted in fiscal year 2016; about 82 percent of the accepted claims were for medical treatment only and received no compensation for time off work or disability-related benefits. Approximately 38,164 claims are active in any given month, of which about 16,741 are receiving time-loss benefits, many of which involve long-term disability and complex medical issues. In fiscal year 2016, retraining plans were completed by 438 injured workers who were not able to return to any type of work at the employer of injury.

***MAJOR INITIATIVES***

The Department of Labor & Industries covers many workplace and safety issues, all of which fall within two primary lines of business: prevention and recovery, each requiring support.

Prevention: L&I works to prevent the things that threaten the lives and livelihoods of the people who live and work in Washington from ever happening. That means preventing workplace injuries and fatalities, the failure of equipment we regulate, violations of worker's wage and labor rights, and fraud.

Recovery: When something does go wrong on the job, L&I strives to ensure remediation and recovery – working to make individuals, workplaces, and communities whole again. Success in recovery means that those who are injured get reconnected to the workforce as quickly as possible, those who are wronged get speedy relief and those who wronged them pay the right penalty or make restitution.

These two lines of business provide key guidance and direction as the agency prepares to better serve its customers of the future through its Business Transformation initiative. The goal is to project the needs and service preferences of future customers in technology, accessibility, and service, and then adapt in advance to prepare for those needs.

L&I also measures specific categories of its work. Governor Jay Inslee directed state agencies to measure performance, improvements, innovation, engagement, transparency and accountability in state government. In response, L&I is focused on five goals:

1. Make workplaces safe.
2. Help injured workers heal and return to work.
3. Make it easy to do business with L&I.
4. Help honest workers and businesses by cracking down on the dishonest ones.
5. Ensure L&I is an employer of choice.

L&I has made great strides in its goal to make workplaces safe by reducing the rate of injury and fostering a culture of safety. Over the last decade, L&I has been instrumental in reducing the occupational illness and injury rate in Washington by almost one third. L&I conducted more than

7,200 workplace safety and health inspections and consultations in 2015. In the most recent year for which complete data is available (2014), Washington had the nation's ninth lowest workplace fatality rate, more than 20 percent lower than the national average.

L&I is a national leader in helping injured workers heal and return to work, with innovative incentives and return-to-work programs. The agency strives to create a culture in which employers, workers, medical providers, vocational experts, and L&I staff focus on maintaining the workers' connection to the workforce, along with their motivation to return to work. This culture, combined with quality medical services and operational efficiencies, saves employers money — an estimated $742 million in reduced benefit liabilities over the past three fiscal years. Through these programs and initiatives, long-term disability has been avoided for 560 injured workers each year; and 4,200 employers received more than $4 million to keep 18,000 workers on light duty while healing. L&I promotes high-quality, evidence-based care and is a national leader in reducing chronic opioid use, which is down to about one percent of incoming time-loss claims. These and other measures help to control health care cost growth, which is about 4.5 percent for 2016.

In late 2015, L&I began offering direct deposit and debit card options for injured workers and crime victims as part of our efforts to make it easier to do business with L&I. In the first full month, we made 1,218 electronic payments. A paper check remains an option, yet in today's world, we expect to see rapid growth in the use of direct deposit and debit card payments. Doing business with L&I also got much easier with our new "My L&I" dashboard for employers that puts the information they want most in plain view. In addition, our agency-wide initiative to better serve limited English proficiency customers includes mandatory eLearning for all staff on how to use a telephone interpreter service when they get a call from a person who speaks limited English.

L&I is cracking down on unscrupulous business practices with improved methods of identifying illegal activities. The agency is working with the Washington State Attorney General's Office to step up criminal and civil enforcement, especially cases of wage theft. L&I investigations resulted in returning more than $4.4 million in wages to workers last fiscal year ($2.8 million in unpaid wages and $1.6 million in prevailing wage). L&I also is continuing efforts to identify and hold accountable workers, providers and businesses that defraud the workers' compensation system. For every dollar spent on combatting workers' compensation fraud in fiscal year 2015, $8.93 was recovered by L&I. In the past two years, the agency referred a total of 28 fraud cases to the Attorney General for consideration of criminal prosecution, 14 in fiscal year 2015 and another 14 in fiscal year 2016.

Ensuring L&I is an employer of choice focuses on providing a culture of trust while developing opportunities for workplace flexibility, such as alternative schedules and telework options. L&I continues to encourage and promote safety and well-being, as well as to provide employees with opportunities to grow and learn. L&I continues to use Lean to empower employees to make decisions that affect their work. Employee-led Lean projects have reduced time for claim processing, improved relationships with customers, streamlined our collections process, and reduced burden on staff. Participation in wellness initiatives is brisk among the agency's employees, with more than 3,000 participants in agency-wide wellness campaigns in fiscal year

2016. L&I also added a lactation room, expanded onsite nutritional food options, and increased engagement in the SmartHealth wellness platform to 60 percent of the workforce.

***ACKNOWLEDGEMENTS***

As in the work and service we provide every day, this Statutory Financial Information Report represents our commitment to maintain excellence in financial reporting, and the financial statements are in conformance with the highest standards of financial accountability.

The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of L&I, the Washington State Office of Financial Management, and the Washington State Investment Board.

Sincerely,

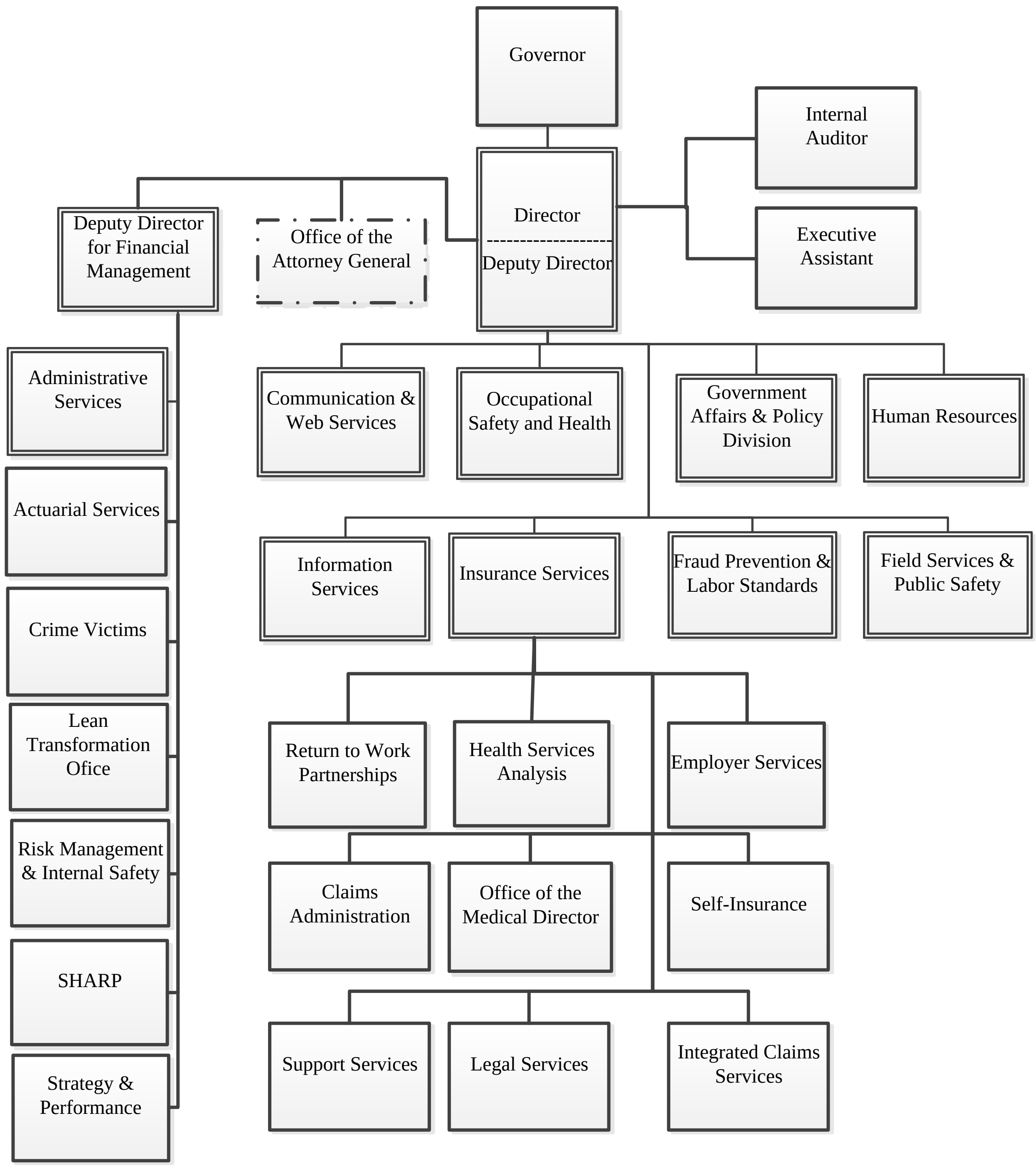
Joel Sacks
Director

Randi Warick
Deputy Director for
Financial Management

Victoria Kennedy
Assistant Director for
Insurance Services

Washington State Department of
Labor & Industries

# Organization Chart
## June 30, 2016



# Financial Section

Washington State Department of
Labor & Industries

***Keep Washington Safe and Working***

CPAs & BUSINESS ADVISORS

**Independent Auditor's Report**

Mr. Joel Sacks Director
Washington State Department of Labor and Industries
Industrial Insurance Fund
Olympia, Washington

**Report on the Financial Statements**
We have audited the accompanying consolidated statutory financial statements (referred to as the financial statements) of Washington State Department of Labor and Industries Industrial Insurance Fund (Fund), which comprise the consolidated statutory statement of admitted assets, liabilities, and contingency reserve as of June 30, 2016 and 2015, and the related consolidated statutory statements of operations and changes in contingency reserve, and consolidated statutory cash flows for the years then ended, and the related notes to the consolidated statutory financial statements.

**Management's Responsibility for the Financial Statements**
Management is responsible for the preparation and fair presentation of these statutory financial statements in accordance with the accounting practices prescribed or permitted by the Insurance Department of the State of Washington. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of statutory financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**
Our responsibility is to express an opinion on these statutory financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

**Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles**
As described in Note 1 to the financial statements, the statutory financial statements are prepared using accounting practices prescribed or permitted by the Insurance Department of the State of Washington, which is a basis of accounting other than accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between the statutory basis of accounting described in Note 1 and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

**Adverse Opinion on U.S. Generally Accepted Accounting Principles**
In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of the Fund as of June 30, 2016 and 2015, or the results of its operations or its cash flows for the years then ended.

**Opinion on Regulatory Basis of Accounting**
In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and contingency reserve of the Fund as of June 30, 2016 and 2015, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note 1.

**Other Matters**

**Required Supplementary Information**
Our audits were conducted for the purpose of forming an opinion on the statutory-basis financial statements taken as a whole. The accompanying supplementary information included in the *Supplemental Schedule of Investment Risk Interrogatories* and the *Summary Investment Schedule* on pages 85 through 89 are required to be presented to comply with the National Association of Insurance Commissioners' Annual Statement Instructions and the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual and are not a required part of the basic statutory financial statements. Such information included in the schedules referred to above is the responsibility of management, is presented for purposes of additional analysis and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other procedures in accordance with the auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

**Other Information**
Our audit was conducted for the purpose of forming opinions on the financial statements. The *Introductory Section, Management's Discussion and Analysis, the Statement of Actuarial Opinion Section, and Schedule of Undiscounted Claims Development* are presented for purposes of additional analysis and are not a required part of the financial statements.

The *Schedule of Undiscounted Claims Development* is the responsibility of management and was derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

The information contained in the *Introductory Section, Management Discussion and Analysis and the Statement of Actuarial Opinion sections* have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we do not express an opinion or provide any assurance on them.

Eide Bailly LLP

Fargo, North Dakota
December 9, 2016

Washington State Department of
Labor & Industries

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# Management's Discussion and Analysis

Our management's discussion and analysis of the state of Washington Industrial Insurance Fund's (State Fund) Statutory Financial Information Report provides an overview of the Industrial Insurance Fund's financial performance for the fiscal years ended June 30, 2016 and 2015. The information included here should be considered along with the transmittal letter, which can be found on pages 3-7 of this report, and the accompanying Consolidated Statutory Financial Statements and notes to the Consolidated Statutory Financial Statements, which follow this narrative.

## History and Information that Makes the State of Washington's Industrial Insurance Fund Unique

Washington was one of the first states to enact workers' compensation laws. The state of Washington's Workmen's Compensation Act established the industrial insurance system in 1911, covering only extremely hazardous work. Washington's workers' compensation insurance was provided solely through the State Fund until 1971, when the system underwent a major overhaul. It was then that the legislature expanded the scope of coverage to virtually all workers and created an option for qualified employers to self-insure, thus paying the cost of claims for their injured workers from their own funds and also assuming responsibility for their own claims administration.

Washington State, through Title 51 of the Revised Code of Washington (RCW), requires all employers, unless exempted, to secure coverage for job-related injuries and illnesses, either by paying insurance premiums to the Industrial Insurance Fund or by self-insuring. Direct private insurance is not authorized, although self-insurers are permitted to reinsure up to 80 percent of their obligations. The state of Washington's Department of Labor and Industries (L&I) operates as an exclusive workers' compensation fund, one of only four remaining in the United States.

In Washington, employers and workers agreed in the 1930s to base premiums on the workers' exposure to risk (hours on the job). Also, Washington requires both the employers and workers to contribute to the cost of Medical Aid premiums.

Under statute RCW 51.16.035, L&I is required to have the lowest possible rates while maintaining solvency of the system. L&I is also required to limit rate fluctuations, follow recognized insurance principles, and stimulate and encourage accident prevention.

## Size and Scope of Washington's Industrial Insurance Fund

The following information provides some context on the size and scope of the Industrial Insurance Fund and how it changed between fiscal years 2016 and 2015.

**Statistics at a Glance**

| | Fiscal Year 2016 | Fiscal Year 2015 |
|---|---|---|
| Employers insured* | 177,000 | 174,000 |
| Workers covered* | 2,800,000 | 2,690,000 |
| Hours reported** | 3,678,000,000 | 3,538,000,000 |
| Premiums assessed (employers' portion)** | $ 1,718,000,000 | $ 1,624,000,000 |
| Premiums assessed (workers' portion)** | $ 408,000,000 | $ 386,000,000 |
| Benefits incurred expense* | $ 1,906,294,000 | $ 1,880,432,000 |
| Number of claims filed | 110,498 | 109,359 |
| Total days paid for lost work | 6,475,281 | 6,841,091 |

Note: The data above is a snapshot as of September following the fiscal year-end.
* Rounded to the nearest thousand
** Rounded to the nearest million

In fiscal year 2016, Washington's workers' compensation system provided insurance for about 2.8 million employees working for 177,000 employers. There were 110,498 claims filed and 95,000 claims accepted. Among the accepted claims, 78,816 of them were medical-only claims. There were 48 fatal pensions awarded in fiscal year 2016. Total premiums assessed from both employers and workers during the current fiscal year were approximately $2,126 million. The business or industry group that filed the greatest number of claims was restaurants and taverns. The most common injuries were traumatic injuries to back muscles, tendons, ligaments, and joints, including the spine and spinal cord.

## Overview of the Financial Statements

The accompanying Consolidated Statutory Financial Statements report the financial position and results of operations for three of the seven Workers' Compensation Program accounts: the Accident, Medical Aid, and Pension Reserve Accounts. These three accounts represent the Workers' Compensation Program Basic Plan, also known as the Industrial Insurance Fund. The Industrial Insurance Fund is accounted for as an enterprise fund of the state of Washington and reports business activities under the accrual basis of accounting, much like a private business enterprise.

This discussion and analysis serves as an introduction to the Industrial Insurance Fund's financial statements, which consist of the following components:

The Consolidated Statutory Statement of Admitted Assets, Liabilities, and Contingency Reserve provides information about the Fund's admitted assets and liabilities and reflects the contingency reserve as of June 30, 2016 and 2015. The Consolidated Statutory Statement of Admitted Assets, Liabilities, and Contingency Reserve can be found on page 31 of this report.

The Consolidated Statutory Statement of Operations and Changes in Contingency Reserve shows how the Fund's contingency reserve changed during the fiscal year. It presents revenues and expenses for fiscal years 2016 and 2015. The Consolidated Statutory Statement of Operations and Changes in Contingency Reserve can be found on page 32 of this report.

The Consolidated Statutory Statement of Cash Flows reflects cash collections and cash payments to arrive at the net increase or decrease in cash and cash equivalents during fiscal years 2016 and 2015. The Consolidated Statutory Statement of Cash Flows can be found on page 33 of this report.

The Notes to the Consolidated Statutory Financial Statements are an integral part of the financial statements and are essential to a full understanding of the Industrial Insurance Fund's financial position and results of operations presented in the financial statements. The Notes to the Consolidated Statutory Financial Statements can be found on pages 37-80 of this report.

These financial statements have been prepared in conformity with the Statutory Accounting Principles (SAP), as promulgated by the National Association of Insurance Commissioners. The main purpose of SAP-based information is to determine solvency. *Solvency* is defined as "the availability of the Industrial Insurance Fund's admitted assets to satisfy its obligations to injured workers and beneficiaries." The Notes to the Consolidated Statutory Financial Statements provide additional information that is essential to a full understanding of the data provided in the Consolidated Statutory Financial Statements.

**Elimination for Consolidated Financial Statements**

It is important to the readers of the Consolidated Statutory Statement of Admitted Assets, Liabilities, and Contingency Reserve that we include details of each account, report the true contingency reserve balance, and show compliance with the statutory Pension Reserve Account transfer requirement. Each year, the Pension Reserve Account's assets and liabilities are evaluated, and a transfer is made between the Accident, Pension Reserve, and Second Injury Accounts, as required by law. In fiscal year 2016, the receivable and the accrued liability of $123,411 million resulting from the transfer from the Accident Account to the Pension Reserve Account was eliminated in order to arrive at an accurate consolidated Industrial Insurance Fund balance.

## Financial Position

The Industrial Insurance Fund's financial position at June 30, 2016 and 2015 was as follows:

**Summary of Financial Position**
**As of June 30, 2016 and 2015**
(dollars in thousands)

| | June 30, 2016 | June 30, 2015 | $ Change | % Change |
|---|---|---|---|---|
| **Admitted Assets** | | | | |
| Fixed income investments | $ 12,665,856 | $ 12,008,655 | $ 657,201 | 5.5% |
| Equities investments | 1,766,364 | 1,895,746 | (129,382) | (6.8%) |
| Short-term investments | 161,305 | 108,857 | 52,448 | 48.2% |
| Receivable for securities | 5 | 5 | - | 0.0% |
| **Total Investments** | 14,593,530 | 14,013,263 | 580,267 | 4.1% |
| Securities lending collateral | 114,835 | 68,406 | 46,429 | 67.9% |
| Interest receivable | 109,871 | 112,021 | (2,150) | (1.9%) |
| Cash and cash equivalents | 12,526 | 11,385 | 1,141 | 10.0% |
| Premiums receivable, net | 558,249 | 531,231 | 27,018 | 5.1% |
| Other assets | 81,716 | 83,796 | (2,080) | (2.5%) |
| **Total Admitted Assets** | $ 15,470,727 | $ 14,820,102 | $ 650,625 | 4.4% |
| **Liabilities and Contingency Reserve** | | | | |
| Benefit liabilities | $ 12,978,157 | $ 12,660,158 | $ 317,999 | 2.5% |
| Claims administration liabilities | 622,547 | 580,764 | 41,783 | 7.2% |
| Retrospective rating adjustments | 162,367 | 184,980 | (22,613) | (12.2%) |
| OPEB liabilities | 53,077 | 42,573 | 10,504 | 24.7% |
| Other liabilities | 46,822 | 61,661 | (14,839) | (24.1%) |
| Collateral from securities lending activities | 114,835 | 68,406 | 46,429 | 67.9% |
| **Total Liabilities** | 13,977,805 | 13,598,542 | 379,263 | 2.8% |
| **Contingency Reserve** | 1,492,922 | 1,221,560 | 271,362 | 22.2% |
| **Total Liabilities and Contingency Reserve** | $ 15,470,727 | $ 14,820,102 | $ 650,625 | 4.4% |

Total admitted assets of $15,471 million increased by $651 million, or 4.4 percent, as compared to the end of fiscal year 2015, primarily due to increases of $580 million in total investments, $46 million in securities lending collateral, and $27 million in premiums receivable.

The most significant changes in the investment balances are from increases of $657 million in fixed income investments and $52 million in short term investments. The increases were partially offset by a $129 million decrease in equities.

- Additional fixed income investments were purchased with the proceeds from rebalancing the equity portfolio. Also, cash collected from operations and net investment income received was reinvested within the fixed income portfolio.

- The increase in short-term investments for fiscal year 2016 is mainly due to timing of investment activities.

- A decrease of $129 million in equities is mainly due to selling $205 million to rebalance the equity portfolio in July 2015 and June 2016 and a decline in the stock market during the first quarter of fiscal year 2016 resulting from uncertainty of global markets due to the economic slowdown in China, as well as other emerging markets, and historically low oil prices. Equities have recovered during the second, third, and fourth quarters of fiscal year 2016, but not enough to offset the larger first quarter loss.

Both assets and liabilities from securities lending activities increased by $46 million as compared to June 30, 2015, due to an increased demand for borrowing securities. The June 30, 2016, balance of cash collateral held for securities lending transactions was $115 million. Additional information on securities lending collateral is included in Note 9 - Sale, Transfer and Servicing of Financial Assets and Extinguishments of Liabilities of this report.

Most of the premiums receivable balance represents the estimated premiums due for the quarter ended June 30, 2016. The estimated receivables have increased by $27 million as compared to June 30, 2015, mostly as a result of an increase in the number of hours reported by employers and premium rate increases in the Medical Aid Account, effective January 1, 2015, and in the Accident Account, effective January 1, 2016.

Total benefit liabilities increased $318 million, or 2.5 percent, to $12,978 million during fiscal year 2016, as shown by the following table:

**Benefit Liabilities**
(in thousands)

| | Fiscal Year 2016 | Fiscal Year 2015 |
|---|---|---|
| **Benefit liabilities, beginning** | $ 12,660,158 | $ 12,372,673 |
| New liabilities incurred, current year | 1,621,358 | 1,662,520 |
| Development on prior years | | |
| Change in reserve discount | 353,097 | 236,214 |
| Other development on prior liabilities | (102,592) | (55,220) |
| Change in discount rate | 34,431 | 36,918 |
| Claim payments | (1,588,295) | (1,592,947) |
| Change in benefit liabilities | 317,999 | 287,485 |
| **Benefit liabilities, ending** | $ 12,978,157 | $ 12,660,158 |

It is expected that benefit liabilities will change every year due to normal activities, such as adding the current accident year liabilities, discounting existing liabilities, and paying claims. In addition, benefit liabilities also changed due to favorable development on prior liabilities and the following managerial decision that had no direct relationship to claim operations: L&I has a plan to reduce the pension discount rate from 6.5 to 4.5 percent by 2023. During fiscal year 2016, the pension discount rate was reduced from 6.4 to 6.3 percent, which increased liabilities by $34 million.

The net increases in benefit liabilities explained above were partially offset by the other development on prior liabilities of $103 million from new information on previously-estimated liabilities. A reduction in the number of anticipated active time-loss claims based on recent data is the main reason for the other development on prior liabilities decrease. Detailed changes in the benefit liabilities are explained in Note 10 - Changes in Benefit and Claims Administration Liabilities of this report.

The Retrospective Rating Program is a voluntary financial incentive program offered by L&I to reduce workplace injuries and costs associated with workers' compensation claims. The program provides an economic incentive to employers by refunding a portion of their workers' compensation premiums if injury claims are below estimates during three annual evaluations. If employer claims are above estimates, an additional premium is assessed to the employer's account. The Retrospective Rating Adjustments liability includes the estimated return of earned premiums, net any additional premiums expected to be assessed through the final adjustment for all current participants. This liability decreased $23 million as compared to June 30, 2015. The decrease was largely due to reduced expected average retrospective rating refund percentages.

Other liabilities decreased $15 million, mainly due to a decrease of $10 million in the payable for securities. The payable for securities had a balance of $10 million as of June 30, 2015, but there were no payables for securities as of June 30, 2016. The payable for securities represents the amount owed for the purchase of investment securities as of the end of the fiscal year that will not be paid until July of the following fiscal year and fluctuates based on investment transaction timing. The remaining decrease is mainly due to an increase in fiscal year 2015, other liabilities, due to the accounting change described in Note 2.

The contingency reserve increased by $271 million due to greater premiums collected than current accident year benefits incurred, investment income, and prior year benefit liabilities that increased less than expected.

## Results of Operations

Industrial Insurance Fund operating results and certain key financial ratios are presented in the following table:

**Summary of Operations and Changes in Contingency Reserve**
**For the Fiscal Years Ended June 30, 2016 and 2015**
(dollars in thousands)

| | Fiscal Year 2016 | Fiscal Year 2015 | $ Change | % Change |
|---|---|---|---|---|
| Net premiums earned | $ 1,963,909 | $ 1,808,152 | $ 155,757 | 8.6% |
| Net investment income earned | 498,499 | 493,408 | 5,091 | 1.0% |
| Net investment realized gains | 137,988 | 58,660 | 79,328 | 135.2% |
| Self-insured reimbursements | 117,441 | 117,987 | (546) | (0.5%) |
| Other income | 53,434 | 54,853 | (1,419) | (2.6%) |
| **Total Revenue Earned** | 2,771,271 | 2,533,060 | 238,211 | 9.4% |
| Net benefits (losses) incurred | 1,906,294 | 1,880,432 | 25,862 | 1.4% |
| Claims administration expenses (LAE) incurred | 212,754 | 205,310 | 7,444 | 3.6% |
| Premium administration expenses incurred | 46,983 | 42,349 | 4,634 | 10.9% |
| Other administration expenses incurred | 41,708 | 42,474 | (766) | (1.8%) |
| Self-insured administration expenses incurred | 28,267 | 27,901 | 366 | 1.3% |
| Non-insurance administration expenses incurred | 55,597 | 56,433 | (836) | (1.5%) |
| **Total Administration Expenses Incurred** | 385,309 | 374,467 | 10,842 | 2.9% |
| **Total Expenses Incurred** | 2,291,603 | 2,254,899 | 36,704 | 1.6% |
| **Net Income** | 479,668 | 278,161 | 201,507 | 72.4% |
| Other changes in contingency reserve | (208,306) | (2,540) | (205,766) | 8101.0% |
| Changes in contingency reserve, net | 271,362 | 275,621 | (4,259) | (1.5%) |
| Beginning contingency reserve, July 1 | 1,221,560 | 945,939 | 275,621 | 29.1% |
| **Ending Contingency Reserve, June 30** | $ 1,492,922 | $ 1,221,560 | $ 271,362 | 22.2% |

Net premiums earned for the current period is the sum of net premiums collected and the changes in premiums receivable and retrospective rating adjustments liability between June 30, 2015, and June 30, 2016. Net premiums earned increased $156 million, mainly due to an increase in the number of hours reported by employers and premium rate increases in the Medical Aid and Accident Accounts. In fiscal year 2016, employers reported 3,695 million hours worked; this figure increased from 3,538 million hours for fiscal year 2015. There has been a steady growth of quarterly standard premiums for 21 quarters since March 31, 2011.

Net investment income earned of $498 million was $5 million higher during fiscal year 2016 than fiscal year 2015. Despite continued low interest rates, interest income from bonds increased, because there were more fixed income investments, as previously discussed.

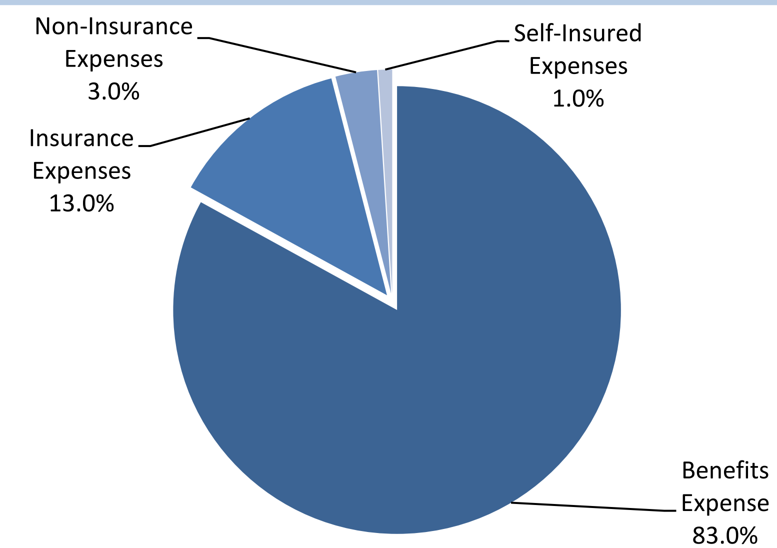
Net realized capital gains from the sale of fixed income and equity investments added $138 million to net income in fiscal year 2016. Realized gains were higher in fiscal year 2016, mostly due to the sale of fixed income and equity securities as a result of investment rebalancing activities.

In fiscal year 2016, benefits incurred increased $26 million from the prior year to $1,906 million. Benefits incurred includes $1,588 million in benefits paid and a $318 million increase in benefit liabilities. The increase in net benefits incurred resulted from the increase in the change in benefit liabilities between fiscal year 2016 and fiscal year 2015.

Total administration expenses incurred increased $10.8 million over the prior year as a result of the following: 1) increases in salaries and benefits due to the 3.0 percent increase in state employee salaries, effective July 1, 2015, as approved by the legislature; 2) increase to the employer's contribution rate for employee retirement plans; 3) increase to the employer's cost for employee health insurance; 4) hiring of additional staff for new programs; and 5) changes in the way that nonadmitted assets are accounted for.

The following chart provides detail on total expenses incurred in fiscal year 2016:

**Fiscal Year 2016 Total Expenses Incurred**




Other changes in the contingency reserve decreased $206 million due to unrealized losses on equities and bonds. The stock market declined and the investment portfolio was rebalanced, as previously mentioned, which resulted in $105 million of unrealized losses in equities. The $77 million of fixed income unrealized losses was due to a decrease in the market value of 36 lower credit quality bonds in the portfolio. It is the Industrial Insurance Fund's investment policy to purchase only investment grade bonds. However, due to unforeseen circumstances, investment grade bonds that were purchased are sometimes downgraded at a later date. Highly-leveraged companies (e.g., oil and mining) that had a reduction in their sales, cash flow, and liquidity due to various factors, such as prolonged low oil prices, the slowdown in China's economy, or Brazil's recession, now have higher debt ratios and have been downgraded.

The biggest contributors to the unrealized loss are Brazil's oil giant, Petrobras, as well as banks and other companies impacted by Brazil's recession. These unrealized losses account for $182 million of the $206 million decrease.

The following ratios, expressed as a percentage of total net premiums earned, are recognized industry measures used to compare one insurance company to another:

**Key Financial Ratios**

| | Fiscal Year 2016 | Fiscal Year 2015 | Fiscal Year 2016 Excluding One-time Adjustments |
|---|---|---|---|
| Loss ratio | 97.1% | 104.0% | 88.2% |
| Loss adjustment expense (LAE) ratio | 10.8% | 11.4% | 10.8% |
| **Loss and LAE Ratio** | **107.9%** | **115.4%** | **99.0%** |
| Underwriting and other expense ratio | 4.5% | 4.7% | 4.5% |
| **Combined Ratio** | **112.4%** | **120.1%** | **103.5%** |
| Less: Net investment income ratio | 25.4% | 27.3% | 25.4% |
| **Operating Ratio** | **87.0%** | **92.8%** | **78.1%** |

- The benefit (loss) and loss adjustment expense (LAE) ratios represent the total costs for processing claims and benefits as a percentage of total net premiums earned. There are many factors that impact loss and LAE ratios, including legislative decisions and claim frequency, severity, and exposure.

- The combined ratio expresses total insurance costs, including benefits and administration expenses incurred, as a percentage of total net premiums earned. When the total insurance costs exceed net premium revenues, the combined ratio is above 100 percent. The Industrial Insurance Fund's rates are set based on the anticipated breakeven rate. Income earned on investments supplements premium revenues to cover expenses so that the lowest possible rates can be set. As a result, it is expected that the Industrial Insurance Fund's combined ratio will exceed 100 percent.

- The operating ratio reflects the combined ratio less the net investment income ratio and is another industry measure of overall financial performance. Ratios above 100 percent indicate that expenses are greater than the sum of premiums and net investment income earned. The operating ratio does not include realized or unrealized investment gains. Insurance companies are motivated to make profits and, therefore, work toward an operating ratio below 100 percent. Unlike other insurance companies, the Industrial Insurance Fund is operated as a part of state government, and in most years, its goal is to break even rather than make a profit. However, the Industrial Insurance Fund has a 10-year plan to increase the contingency reserve to 14 percent of liabilities. The contingency reserve was 10.8 percent of liabilities as of June 30, 2016.

- In fiscal year 2016, benefit liabilities increased $34 million as a result of managerial decisions that have no direct relationship to claim operations as discussed above. If these one-time adjustments had not been made, the loss ratio would have been 99.0 percent and the operating ratio would have been 78.1 percent.

- The combined ratio decreased from 120.1 percent in fiscal year 2015 to 112.4 percent in fiscal year 2016. The combined ratio decreased due to an increase in premiums earned.

- The operating ratio decreased from 92.8 percent in fiscal year 2015 to 87.0 percent in fiscal year 2016 as a result of the decrease in the combined ratio for the reasons stated above.

- The LAE ratio of 10.8 percent and the underwriting and other expense ratio of 4.5 percent remain consistently lower when compared to the workers' compensation insurance industry.

**Cash Flows and Liquidity**

**Cash Flows -** The primary sources of cash were from premiums collected and investment income. The primary uses of cash were for benefit payments, administration expenses, and purchases of investments.

Cash flows of the Industrial Insurance Fund are summarized as follows:

**Cash Flow Summary**
**For the Fiscal Years Ended June 30, 2016 and 2015**
(dollars in thousands)

| | Fiscal Year 2016 | Fiscal Year 2015 | $ Change | % Change |
|---|---|---|---|---|
| **Operations** | | | | |
| Net premiums collected | $ 1,902,084 | $ 1,813,743 | $ 88,341 | 4.9% |
| Other reimbursements and income | 146,092 | 108,949 | 37,143 | 34.1% |
| Net benefits paid | (1,588,295) | (1,592,947) | 4,652 | (0.3%) |
| Insurance administration expenses paid | (244,508) | (241,079) | (3,429) | 1.4% |
| Self-insured administration expenses paid | (27,449) | (26,480) | (969) | 3.7% |
| Non-insurance administration expenses paid | (53,449) | (51,532) | (1,917) | 3.7% |
| **Operating Cash Flow In (Out)** | 134,475 | 10,654 | 123,821 | 1162.2% |
| **Investment Activities** | | | | |
| Investment income | 499,812 | 487,010 | 12,802 | 2.6% |
| Net realized gains | 137,988 | 58,660 | 79,328 | 135.2% |
| Purchases, net | (766,608) | (550,922) | (215,686) | 39.2% |
| Investment management expenses | (4,526) | (4,317) | (209) | 4.8% |
| **Investment Cash Flow In (Out)** | (133,334) | (9,569) | (123,765) | 1293.4% |
| **Net increase in cash** | $ 1,141 | $ 1,085 | $ 56 | 5.2% |

Net premiums collected increased $32 million in the Accident Account and $56 million in the Medical Aid Account over the prior year, for a total increase of $88 million. This increase was mainly due to a higher number of hours reported by employers and premium rate increases in the Medical Aid Account, effective January 2015, and in the Accident Account, effective January 2016.

Other reimbursements and income collected increased $37 million, mainly due to fiscal year 2015 experting, which determined that the Second Injury Account needed to transfer $33.5 million to the Pension Reserve Account. During fiscal year 2015, pension liabilities for self-insured second injuries were high due to a shortfall in investment income, an increase in liabilities due to the new mortality table, and an increase in liabilities due to the reduction in the discount rate from 6.5 to 6.4%. In fiscal year 2014, only $3.5 million was transferred from the Second Injury Account to the Pension Reserve Account.

Net benefits paid decreased $5 million when compared to the prior year, as explained below:

- The Accident Account's $18 million decrease in net benefits paid is mainly due to a decline in current active time-loss claims.

- The Medical Aid Account's $4 million decrease in net benefits paid resulted mainly from fewer active medical claims, two fewer days paid during the fiscal year, and relatively low medical inflation during the year.

- The Pension Account's net benefits paid increased $17 million, mainly because of higher numbers of pensioners receiving benefits, together with higher average monthly benefits.

Insurance administration expenses paid have increased $3 million, or 1.4 percent, primarily due to the increases in salaries and benefits and the 3.0 percent increase in state employee salaries effective July 1, 2015, as approved by the legislature, increases to the employer contribution rate for retirement and employer's cost for health insurance, as well as the hiring of additional staff for new programs.

The increase of $13 million in net investment income collected was mainly due to an increase in bond investment income, because there were additional fixed income securities in fiscal year 2016.

There was $138 million in net realized gains in fiscal year 2016, an increase of $79 million from the previous year. The increase is due to the sale of equities and fixed income investments as a result of rebalancing activities, as discussed above.

Investment purchases exceeded sales by $216 million, mainly due to reinvesting investment income and net income.

**Liquidity -** The Industrial Insurance Fund's operations require sufficient liquidity to meet both short-term and long-term requirements. Resources to ensure short-term liquidity come from two basic factors:

- L&I may increase rates in order to increase its contingency reserve, resulting in positive cash flow.

- Premiums are paid to L&I every three months.

The Industrial Insurance Fund has generally met its operating requirements by maintaining appropriate levels of liquidity in its investment portfolio and through reinvesting positive cash flow. The Industrial Insurance Fund is able to match projected cash inflows from premiums and investment income from its portfolio with projected cash outflows for payment of benefits.

**Future Plan**

In 2012, L&I adopted a 10-year plan to increase the contingency reserve to a level between 13 and 15 percent of liabilities, while reducing the rate used to discount pension liabilities from 6.5 to 4.5 percent by 2023. L&I took the first step to reduce the pension discount rate in April 2015, moving from 6.5 to 6.4 percent. The second step to reduce the pension discount rate occurred in April 2016, moving from 6.4 to 6.3 percent.

L&I's goal for fiscal year 2016 was to increase the contingency reserve balance from $1,222 million to $1,293 million by increasing premium rates and reducing benefit costs by $35 to $70 million. The fiscal year 2016 goal was met with the contingency reserve balance increasing to $1,493 million.

L&I plans to increase the contingency reserve to a range between $1,493 million to $1,583 million, while reducing the discount rate to a range between 6.3 and 5.75 percent during fiscal year 2017. The final goal amounts will be based on discussions with the Workers' Compensation Finance Committee. There is additional information in Note 17 - Subsequent Events that will impact the fiscal year 2017 contingency reserve.

**Requests for Information**

This report is designed to provide a general overview of the Industrial Insurance Fund and to illustrate the Fund's financial position and results of operations to interested parties. If you have any questions about this report or need additional financial information, please contact the Chief Accounting Officer at the Department of Labor & Industries, P.O. Box 44833, Olympia, Washington 98504-4833.

In accordance with the Revised Code of Washington (RCW) 51.44.115, L&I also publishes a Comprehensive Annual Financial Report (CAFR) for the Workers' Compensation Program. This report is prepared in compliance with Generally Accepted Accounting Principles (GAAP).

The Industrial Insurance Fund Statutory Financial Information Report and the Workers' Compensation Program CAFR are available at L&I's website at:
http://www.lni.wa.gov/ClaimsIns/Insurance/Learn/StateFund/Reports.

Washington State Department of
Labor & Industries

*Keep Washington Safe and Working*

# Consolidated Statutory Financial Statements

Washington State Department of
Labor & Industries

***Keep Washington Safe and Working***

## Consolidated Statutory Statement of Admitted Assets, Liabilities, and Contingency Reserve

As of June 30, 2016 and 2015

(rounded to the nearest thousand)

| | Accident Account | Medical Aid Account | Pension Reserve Account | Elimination for Consolidated Statements | Total June 30, 2016 | Total June 30, 2015 |
|---|---|---|---|---|---|---|
| **Admitted Assets** | | | | | | |
| **Cash and Investments** | | | | | | |
| **Investments, net** | | | | | | |
| Fixed income | $ 4,716,417,000 | $ 4,298,570,000 | $ 3,650,869,000 | $ - | $ 12,665,856,000 | $12,008,655,000 |
| Equities | 563,654,000 | 762,931,000 | 439,779,000 | - | 1,766,364,000 | 1,895,746,000 |
| Short-term | 53,420,000 | 45,472,000 | 62,413,000 | - | 161,305,000 | 108,857,000 |
| Receivable for securities | 2,000 | 2,000 | 1,000 | - | 5,000 | 5,000 |
| **Total Investments** | 5,333,493,000 | 5,106,975,000 | 4,153,062,000 | - | 14,593,530,000 | 14,013,263,000 |
| Securities lending collateral | 88,568,000 | 254,000 | 26,013,000 | - | 114,835,000 | 68,406,000 |
| Interest receivable | 43,863,000 | 34,086,000 | 31,922,000 | - | 109,871,000 | 112,021,000 |
| Cash and cash equivalents | 6,835,000 | 3,597,000 | 2,094,000 | - | 12,526,000 | 11,385,000 |
| **Total Cash and Investments** | 5,472,759,000 | 5,144,912,000 | 4,213,091,000 | - | 14,830,762,000 | 14,205,075,000 |
| **Other Assets** | | | | | | |
| Premiums receivable, net, incl. earned but-unbillec | 346,453,000 | 211,796,000 | - | - | 558,249,000 | 531,231,000 |
| Real estate and improvements | | | | | | |
| (less $0 encumbrances) | 18,589,000 | 18,588,000 | - | - | 37,177,000 | 34,501,000 |
| Self-insurance receivables, net | 3,690,000 | 3,612,000 | 6,763,000 | - | 14,065,000 | 14,300,000 |
| Miscellaneous receivables, net | 1,508,000 | 608,000 | 151,769,000 | (123,411,000) | 30,474,000 | 34,995,000 |
| **Total Other Assets** | 370,240,000 | 234,604,000 | 158,532,000 | (123,411,000) | 639,965,000 | 615,027,000 |
| **Total Admitted Assets** | $ 5,842,999,000 | $ 5,379,516,000 | $ 4,371,623,000 | $ (123,411,000) | $ 15,470,727,000 | $14,820,102,000 |
| **Liabilities and Contingency Reserve** | | | | | | |
| **Liabilities** | | | | | | |
| Benefits | $ 4,708,421,000 | $ 3,927,450,000 | $ 4,342,286,000 | $ - | $ 12,978,157,000 | $12,660,158,000 |
| **Other Liabilities** | | | | | | |
| Claim administration | 218,746,000 | 403,801,000 | - | - | 622,547,000 | 580,764,000 |
| Retrospective rating adjustments | 162,367,000 | - | - | - | 162,367,000 | 184,980,000 |
| Accrued liabilities | | | | | | |
| OPEB claim administration | 11,840,000 | 16,017,000 | - | - | 27,857,000 | 22,838,000 |
| OPEB other administration | 15,114,000 | 10,106,000 | - | - | 25,220,000 | 19,735,000 |
| Other accrued liabilities | 148,101,000 | 18,319,000 | 3,324,000 | (123,411,000) | 46,333,000 | 51,207,000 |
| Deferred revenue | 325,000 | 164,000 | - | - | 489,000 | 493,000 |
| Payable for securities | - | - | - | - | - | 9,961,000 |
| Collateral from securities lending activities | 88,568,000 | 254,000 | 26,013,000 | - | 114,835,000 | 68,406,000 |
| **Total Other Liabilities** | 645,061,000 | 448,661,000 | 29,337,000 | (123,411,000) | 999,648,000 | 938,384,000 |
| **Total Liabilities** | 5,353,482,000 | 4,376,111,000 | 4,371,623,000 | (123,411,000) | 13,977,805,000 | 13,598,542,000 |
| **Contingency Reserve** | 489,517,000 | 1,003,405,000 | - | - | 1,492,922,000 | 1,221,560,000 |
| **Total Liabilities and Contingency Reserve** | $ 5,842,999,000 | $ 5,379,516,000 | $ 4,371,623,000 | $ (123,411,000) | $ 15,470,727,000 | $14,820,102,000 |

The Notes to the Statutory Financial Statements are an integral part of this statement.

The source of this financial information is the Washington State Agency Financial Reporting System with adjustments for statutory basis of accounting.

# Consolidated Statutory Statement of Operations and Changes in Contingency Reserve

For the Fiscal Years Ended June 30, 2016 and 2015

(rounded to the nearest thousand)

| | Accident Account | Medical Aid Account | Pension Reserve Account | Total Fiscal Year 2016 | Total Fiscal Year 2015 |
|---|---|---|---|---|---|
| **Revenues** | | | | | |
| Net standard premiums earned | $ 1,299,794,000 | $ 820,453,000 | $ - | $ 2,120,247,000 | $ 1,995,759,000 |
| Less net retrospective rating adjustments | (156,338,000) | - | - | (156,338,000) | (187,607,000) |
| Net premiums earned | 1,143,456,000 | 820,453,000 | - | 1,963,909,000 | 1,808,152,000 |
| Net investment income earned | 197,326,000 | 155,543,000 | 145,630,000 | 498,499,000 | 493,408,000 |
| Net fixed income investment realized gains | 23,023,000 | 20,582,000 | 19,886,000 | 63,491,000 | 40,573,000 |
| Net equity investment realized gains | 40,028,000 | 34,233,000 | 236,000 | 74,497,000 | 18,087,000 |
| Self-insured administration expense assessments | 14,737,000 | 14,159,000 | - | 28,896,000 | 23,937,000 |
| Self-insured second injury pension reserve assessments | - | - | 65,459,000 | 65,459,000 | 72,169,000 |
| Self-insured cash funded & bonded pension reimbursement | - | - | 23,086,000 | 23,086,000 | 21,881,000 |
| Fines, penalties, and interest | 41,907,000 | 2,003,000 | 63,000 | 43,973,000 | 46,645,000 |
| Other income | 7,651,000 | 1,810,000 | - | 9,461,000 | 8,208,000 |
| **Total Revenues Earned** | 1,468,128,000 | 1,048,783,000 | 254,360,000 | 2,771,271,000 | 2,533,060,000 |
| **Expenses** | | | | | |
| Benefits incurred | 598,498,000 | 704,355,000 | 603,441,000 | 1,906,294,000 | 1,880,432,000 |
| Administration expenses incurred: | | | | | |
| Insurance expenses incurred: | | | | | |
| Claims administration expenses incurred | 76,341,000 | 136,413,000 | - | 212,754,000 | 205,310,000 |
| Premium administration expenses incurred | 23,191,000 | 23,792,000 | - | 46,983,000 | 42,349,000 |
| General insurance administration expenses incurred | 13,427,000 | 5,968,000 | - | 19,395,000 | 20,894,000 |
| Other agencies insurance expenses incurred | 11,057,000 | 11,256,000 | - | 22,313,000 | 21,580,000 |
| Total insurance expenses incurred | 124,016,000 | 177,429,000 | - | 301,445,000 | 290,133,000 |
| Self-insured administration expenses incurred | 14,853,000 | 13,414,000 | - | 28,267,000 | 27,901,000 |
| Non-insurance administration expenses incurred | 39,562,000 | 16,035,000 | - | 55,597,000 | 56,433,000 |
| Total administration expenses incurred | 178,431,000 | 206,878,000 | - | 385,309,000 | 374,467,000 |
| **Total Expenses Incurred** | 776,929,000 | 911,233,000 | 603,441,000 | 2,291,603,000 | 2,254,899,000 |
| **Net Income (Loss) Before Transfers** | 691,199,000 | 137,550,000 | (349,081,000) | 479,668,000 | 278,161,000 |
| **Transfers In (Out)** | | | | | |
| Pension funding transfers | (380,833,000) | - | 380,833,000 | - | - |
| **Net Transfers In (Out)** | (380,833,000) | - | 380,833,000 | - | - |
| **Net Income (Loss)** | 310,366,000 | 137,550,000 | 31,752,000 | 479,668,000 | 278,161,000 |
| **Other Changes in Contingency Reserve** | | | | | |
| Fixed income unrealized gains (losses) | (35,358,000) | (21,225,000) | (20,004,000) | (76,587,000) | (5,132,000) |
| Equities unrealized gains (losses) | (41,823,000) | (51,789,000) | (11,631,000) | (105,243,000) | 28,823,000 |
| Change in nonadmitted assets | (23,584,000) | (2,775,000) | (117,000) | (26,476,000) | (26,231,000) |
| **Change in Contingency Reserve, Net** | 209,601,000 | 61,761,000 | - | 271,362,000 | 275,621,000 |
| Beginning contingency reserve, July 1 | 279,916,000 | 941,644,000 | - | 1,221,560,000 | 945,939,000 |
| **Ending Contingency Reserve, June 30** | $ 489,517,000 | $ 1,003,405,000 | $ - | $ 1,492,922,000 | $ 1,221,560,000 |

The Notes to the Consolidated Statutory Financial Statements are an integral part of this statement.
The source of this financial information is the Washington State Agency Financial Reporting System with adjustments for statutory basis of accounting.

## Consolidated Statutory Statement of Cash Flows
For the Fiscal Years Ended June 30, 2016 and 2015
(rounded to the nearest thousand)

| | Accident Account | Medical Aid Account | Pension Reserve Account | Total Fiscal Year 2016 | Total Fiscal Year 2015 |
|---|---|---|---|---|---|
| Standard premiums collected | $ 1,270,917,000 | $ 810,118,000 | $ - | $ 2,081,035,000 | $ 1,957,968,000 |
| Less retrospective rating adjustments | (178,951,000) | - | - | (178,951,000) | (144,225,000) |
| Net premiums collected | 1,091,966,000 | 810,118,000 | - | 1,902,084,000 | 1,813,743,000 |
| Self-insured administration expense reimbursements | 14,148,000 | 13,593,000 | - | 27,741,000 | 24,129,000 |
| Self-insured second injury pension reserve reimbursements | - | - | 70,571,000 | 70,571,000 | 42,258,000 |
| Self-insured cash funded and bonded pension reimbursements | - | - | 24,558,000 | 24,558,000 | 15,065,000 |
| Fines, penalties, and interest | 24,775,000 | 1,673,000 | - | 26,448,000 | 26,622,000 |
| Other income (expenses) | 676,000 | (3,881,000) | (21,000) | (3,226,000) | 875,000 |
| Fund transfers in (out) | (391,378,000) | - | 391,378,000 | - | - |
| **Operating Cash Flow In** | 740,187,000 | 821,503,000 | 486,486,000 | 2,048,176,000 | 1,922,692,000 |
| Benefits paid | 578,087,000 | 571,303,000 | 438,905,000 | 1,588,295,000 | 1,592,947,000 |
| Administration expenses | | | | | |
| Insurance expenses | | | | | |
| Claims administration expenses | 60,502,000 | 99,914,000 | - | 160,416,000 | 159,506,000 |
| Premium administration expenses | 21,638,000 | 22,593,000 | - | 44,231,000 | 40,453,000 |
| General insurance administration expenses | 12,904,000 | 5,791,000 | - | 18,695,000 | 20,270,000 |
| Other agencies insurance expenses | 10,617,000 | 10,549,000 | - | 21,166,000 | 20,850,000 |
| Total insurance expenses | 105,661,000 | 138,847,000 | - | 244,508,000 | 241,079,000 |
| Self-insured administration expenses | 14,341,000 | 13,108,000 | - | 27,449,000 | 26,480,000 |
| Non-insurance administration expenses | 37,871,000 | 15,578,000 | - | 53,449,000 | 51,532,000 |
| **Total Administration Expenses Paid** | 157,873,000 | 167,533,000 | - | 325,406,000 | 319,091,000 |
| **Operating Cash Flow Out** | 735,960,000 | 738,836,000 | 438,905,000 | 1,913,701,000 | 1,912,038,000 |
| **Net Operating Cash Flow In (Out)** | 4,227,000 | 82,667,000 | 47,581,000 | 134,475,000 | 10,654,000 |
| Investment income - fixed income | 197,791,000 | 155,033,000 | 145,625,000 | 498,449,000 | 484,741,000 |
| Investment income - equities | 449,000 | 600,000 | 314,000 | 1,363,000 | 2,269,000 |
| Net realized gains on investments | 63,051,000 | 54,815,000 | 20,122,000 | 137,988,000 | 58,660,000 |
| Net (purchases) sales of investments | (264,313,000) | (290,541,000) | (211,754,000) | (766,608,000) | (550,922,000) |
| Investment expenses | (1,678,000) | (1,576,000) | (1,272,000) | (4,526,000) | (4,317,000) |
| **Total Investment Cash Flow In (Out)** | (4,700,000) | (81,669,000) | (46,965,000) | (133,334,000) | (9,569,000) |
| **Net Cash Flow In (Out)** | (473,000) | 998,000 | 616,000 | 1,141,000 | 1,085,000 |
| Beginning Cash, July 1 | 7,308,000 | 2,599,000 | 1,478,000 | 11,385,000 | 10,300,000 |
| **End of Period Cash** | $ 6,835,000 | $ 3,597,000 | $ 2,094,000 | $ 12,526,000 | $ 11,385,000 |

The Notes to the Consolidated Statutory Financial Statements are an integral part of this statement.
The source of this financial information is Washington State's Agency Financial Reporting System (AFRS) with adjustments for statutory basis of accounting.

Washington State Department of
Labor & Industries

*Keep Washington Safe and Working*

# Notes to the Consolidated Statutory Financial Statements

For the Fiscal Years Ended June 30, 2016 and 2015

## Index

Washington State Department of
Labor & Industries

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## Note 1 - Summary of Significant Accounting Policies

### 1.A. Nature of Operations

The state of Washington's Department of Labor & Industries (L&I) administers the state's Workers' Compensation Program. Through Title 51 of the Revised Code of Washington (RCW), Washington State requires all employers, unless excluded or exempt, to secure coverage for job-related injuries and illnesses, either by paying insurance premiums to the Industrial Insurance Fund or by self-insuring. L&I is the exclusive writer of workers' compensation insurance in the state of Washington for all businesses except the self-insured. Direct private insurance is not authorized, although self-insurers are permitted to reinsure up to 80 percent of their obligations.

Chapter 51.44 RCW provides six benefit accounts: the Accident, Medical Aid, Pension Reserve, Supplemental Pension, Second Injury, and the Self-Insured Employer Overpayment Reimbursement Accounts, primarily to make compensation payments to injured workers or to medical providers for rehabilitation services to injured workers. A seventh account, called the Industrial Insurance Rainy Day Fund Account, was created to receive transfers of funds from the Accident and Medical Aid Accounts when assets for those accounts combined are between 10 and 30 percent in excess of their funded liabilities. The funds are then set aside to reduce a rate increase or aid businesses during or recovering from economic recessions. The Industrial Insurance Rainy Day Fund Account did not have any activity during fiscal year 2016 or balance on June 30, 2016. These seven accounts are known collectively as the Workers' Compensation Program.

The Accident, Medical Aid, and Pension Reserve Accounts are referred to as "the Industrial Insurance Fund" and are the focus of this report. The Supplemental Pension, Second Injury, Self-Insured Employer Overpayment Reimbursement, and Industrial Insurance Rainy Day Fund Accounts are not part of the Industrial Insurance Fund and are not included in this report.

The Industrial Insurance Fund is self-sustaining through the ability to assess the appropriate rates of insurance premiums and prudent investment management. The three accounts are maintained on an actuarially solvent basis, except that a cash-flow basis is used for the components of the Pension Reserve Account in which self-insured employers guarantee related benefits with a surety bond. The accompanying consolidated statutory statements report on the financial position and results of operations of the Industrial Insurance Fund.

### 1.A.1. Description of the Industrial Insurance Fund

There are three accounts making up the Industrial Insurance Fund: the Accident, Medical Aid, and Pension Reserve Accounts.

The Accident Account was established on July 1, 1947, per RCW 51.44.010, and pays compensation directly to injured workers for lost wages during temporary disability and permanent partial disability awards. It also pays costs for vocational retraining and for structured settlements. Pursuant to RCW 51.44.070, funds from the Accident Account are to be transferred to the Pension Reserve Account for the present value of pensions awarded to survivors of fatally injured workers and to workers who have a permanent total disability.

Revenues for this account come from employer-paid premiums based on individual employers' reported payroll hours and are reported net of refunds. Employers may elect to have their premiums retrospectively rated with an annual adjustment for actual benefits incurred. The retrospective adjustment calculation considers both the Accident and Medical Aid Accounts' experience and premiums together and may result in either a rebate of premiums paid or an assessment of additional premiums due. All retrospective premium adjustments are financed entirely through the Accident Account.

On behalf of injured workers, the Medical Aid Account, established on July 1, 1917, per RCW 51.44.020, pays for the cost of medical, vocational rehabilitation services, and Stay at Work reimbursements. Equal contributions from employers and employees fund this account. It is the employer's responsibility to collect the employee portion of the medical aid premium and submit the employee and employer contributions to L&I quarterly.

The Pension Reserve Account pays benefits to the surviving spouse or dependent of fatally injured workers and to all permanently and totally disabled workers. This includes benefits for pensions awarded to employees of self-insured employers.

Funding for pension payments is generated by transfers from the Accident and Second Injury Accounts and cash-funded or bonded pension payments from self-insured employers. Funding required to cover the estimated present cash value of monthly pension payments is calculated on the basis of an annuity; such annuity values are based upon L&I's experience as to rates of mortality, disability, remarriage, and interest, according to RCW 51.44.070.

**1.B. Accounting Practices and Basis of Presentation**

The Industrial Insurance Fund follows the Statutory Accounting Principles (SAP), which include the Statements of Statutory Accounting Principles (SSAP), as promulgated by the National Association of Insurance Commissioners (NAIC), as directed by RCW 51.44.115. The SAP are very conservative in nature and are designed to protect injured workers to ensure that, in the event of liquidation, sufficient amounts have been set aside to provide for outstanding claims. This accounting basis is used to present solvency and the adequacy of premium rates.

The SAP are required to be used by property and casualty insurance enterprises in the United States (U.S.) when reporting their financial position to state insurance regulators, subject to any differences prescribed or permitted by each state's law. The NAIC defines prescribed accounting practices as "… those practices that are incorporated directly or by reference by state laws, regulations and general administrative rules applicable to all insurance enterprises domiciled in a particular state. The NAIC Accounting Practices and Procedures Manual (AP&P) is not intended to preempt states' legislative and regulatory authority."[1] Washington's prescribed differences from the NAIC are addressed in RCW 48.13.071, which provides limits on investments. The NAIC defines permitted practices as "…practices specifically requested by an insurer that depart from NAIC SAP and state prescribed accounting practices, and have received approval from the

[1] NAIC AP&P Manual as of March 2016, Section: Preamble Questions and Answers, Question 2, page P-13.

insurer's domiciliary state regulatory authority."[2] Financial reporting, operating and other guidance that is codified in statute that relates to a statutory reporting entity and departs from NAIC SAP is also generally accepted as prescribed practices.

In accordance with Title 51 RCW and Title 296 of the Washington Administrative Code (WAC), the Industrial Insurance Fund is administered by L&I. Pursuant to Title 48 RCW and Title 284 WAC, L&I is not required to file annual statements with the Washington State Office of the Insurance Commissioner (OIC). The Industrial Insurance Fund is not required to report to the OIC or complete an annual statement in accordance with the NAIC annual statement filing instructions. Title 51 directs the industrial insurance fund to establish reserving methodologies considering rates of mortality, disability, remarriage and interest. Accordingly the Fund established a practice of discounting on a non-tabular basis in a manner that complies with the guidance supplied in the Title. SSAP No. 65 allows discounting fixed and reasonably-determinable payments on a tabular-only basis. Non-tabular discounting is only permitted in certain instances in which states have prescribed or permitted practices to allow it, which is the case for the Fund. (See Note 1.C.3 and Note 12.B for additional information on discounting methodology and non-tabular discounting.)

In addition, the Industrial Insurance Fund recognizes a liability for the net Other Postemployment Benefit (OPEB) obligation which includes the unfunded actuarial accrued liability amortized over thirty years. The Industrial Insurance Fund participates in a multiemployer OPEB plan. SSAP No. 92 states that employers with multiemployer plans are not required to recognize the unfunded status of the OPEB plan, but are only required to recognize the required contribution to the plan for the period reported. The Fund has elected to record this liability given the basis for conservatism within statutory accounting principles and in consideration that the impact of this election does not have a material impact on the financial statements taken as a whole.

[2] NAIC AP&P Manual as of March 2016, Section: Preamble Questions and Answers, Question 2, page P-13.

The following table reconciles the Industrial Insurance Fund's net income and contingency reserve as reported on the accompanying financial statements and what they would have been if they were recorded under NAIC SAP requirements:

| Effect of Prescribed and Permitted Practices | | | | | |
|---|---|---|---|---|---|
| | SSAP # | F/S Page | F/S Line # | As of and For the Fiscal Year Ended June 30, 2016 | As of and For the Fiscal Year Ended June 30, 2015 |
| **Net Income, WA Basis** | | | | **$ 479,668,000** | **$ 278,161,000** |
| Prescribed Non-tabular discounting | 65 | 31 | Benefits | (115,377,000) | 46,125,000 |
| Permitted OPEB administration liability | 92 | 31 | OPEB | 10,504,000 | 10,274,000 |
| **Net Income, NAIC SAP Basis** | | | | **$ 374,795,000** | **$ 334,560,000** |
| **Contingency Reserve, WA Basis** | | | | **$ 1,492,922,000** | **$ 1,221,560,000** |
| Prescribed Non-tabular discounting | 65 | 31 | Benefits | (1,801,253,000) | (1,685,876,000) |
| Permitted OPEB administration liability | 92 | 31 | OPEB | 53,077,000 | 42,573,000 |
| **Contingency Reserve, NAIC SAP Basis** | | | | **$ (255,254,000)** | **$ (421,743,000)** |

* F/S Page 31 means that Liabilities and the Contingency Reserve are primarily impacted

The financial statement layout and terminology were selected based on the terminology and formatting customary to governmental insurance funds. The Industrial Insurance Fund refers to losses as "benefits" and loss adjustment expenses as "claims administration expenses." Any surplus remaining in the Fund is referred to as "contingency reserve."

### 1.B.1. Use of Estimates

The preparation of financial information in conformity with SAP requires management to make estimates and assumptions that affect the reported amounts of admitted assets, liabilities, and contingency reserve at the date of the financial information and the reported amounts of revenues and expenses during the reporting period. Material estimates that are susceptible to significant changes include benefit and claims administration liabilities, premium receivables, self-insurance receivables, retrospective rating adjustment liabilities, and accrued liabilities for other postemployment benefits. Actual results could differ materially from those estimates.

Management's estimates are based on its knowledge of and experience with past and current events and circumstances and its assumptions about conditions it expects will exist in the future. The most significant estimates made in these statutory financial statements are the benefit and claims administration liabilities at the date of the financial information. Factors relevant to the estimation of these liabilities include the estimation of the ultimate frequency and severity of losses, the level of inflation of future medical costs over long periods of time, the future legal environment, and the amount of future expenses required to investigate and settle claims. Management's estimates are reviewed after the fiscal year-end by a nationally recognized, qualified consulting actuarial firm. The independent actuarial firm's opinion is included at the end of this report.

### 1.B.2. Differences between SAP and GAAP

The SAP followed by the Industrial Insurance Fund vary in some respects from Generally Accepted Accounting Principles (GAAP) as promulgated by GASB. Some of the most significant differences between SAP and GAAP are as follows:

- Investments in bonds are reported for SAP at amortized cost or market value based on their NAIC designation; for GAAP, investments in bonds are reported at fair value.

- For SAP, all mortgage-backed and other loan-backed securities are adjusted for the effects of changes in prepayment assumptions using the retrospective method, which equates the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased. Under GAAP, all mortgage-backed and other loan-backed securities are reported at fair value.

- SAP assets designated as *nonadmitted assets* are defined as “assets having economic value other than those which can be used to fulfill policyholder obligations and assets unavailable due to encumbrances or third party interests” and are excluded from total admitted assets. These assets consist primarily of premium receivables in collection that have been outstanding for over ninety days, office furniture, equipment, internally developed software, and prepaid expenses. Nonadmitted assets are charged against the contingency reserve unless otherwise specifically addressed within the NAIC’s AP&P Manual. Under GAAP, premium receivables are presented net of allowance for doubtful accounts, furniture, equipment and internally developed software are presented net of accumulated depreciation, and prepaid expenses are presented at full cost.

- SAP limits the aggregate amount of admitted electronic data processing equipment and operating system software, net of accumulated depreciation, to 3 percent of the reporting entity’s capital and surplus. Under GAAP, computer equipment and software purchases meeting the state’s capitalization criteria are recorded as assets, net of accumulated depreciation, with no limitations.

- The focus of SAP accounting is solvency; therefore, it is concerned with assets that can be used immediately to cover benefit liabilities. GAAP accounting is focused on “going concern,” which assumes that an entity has the ability to survive, and therefore, assets and liabilities are presented in the order of liquidity and classified as current and non-current.

- The Consolidated Statutory Statement of Operations and Changes in Contingency Reserve presents premiums earned and investment income as the primary revenue sources, and expenses are presented as activities. GAAP presentations separate operating income from investment income, since investment activity is not normally a primary revenue source. GAAP also presents expenses by character rather than by the purpose of the item purchased or service obtained and the net effect of revenues and expenses as a change in net position.

- Both SAP and GAAP require the statement of cash flows to be prepared using the direct method. However, the statutory statement of cash flows differs in certain aspects from the presentation required by GAAP. On the SAP Consolidated Statement of Cash Flows, "Cash Flows In" includes operating transfers and other income. "Cash Flows Out" is categorized by benefits paid and administration expenses. The GAAP statement of cash flows includes a reconciliation between operating income from the statement of operations and cash flows from operating activities.

### 1.C. Significant Accounting Policies

#### 1.C.1. Recognition of Premiums

Workers' compensation insurance premiums are determined by individual employers' reported payroll hours and insurance rates based on each employer's risk classification(s) and past experience. In addition to its regular premium plans, the Industrial Insurance Fund offers a Retrospective Premium Rating Plan, under which an employer's premiums are adjusted annually for up to three years following the plan year, based on the employer's actual loss experience.

Premiums are due within 30 days following each calendar quarter in which payroll hours are reported. Net premiums receivable reported in the financial statement is an actuarial estimate of the two most recent quarters' uncollected premium balances, based on past collection statistics, growth projection, observed development of premiums reported, statistical analysis, and other factors, including actuarial judgment. This amount represents the estimated premiums that will ultimately be collected. All premium receivables exceeding 90 days in age are adjusted as nonadmitted assets in the current period and are not included in the net premiums receivable amount. For premium receivables over 90 days in age, collection efforts are continued until the premiums are collected or all legal means are exhausted.

According to SSAP No. 53, a premium deficiency reserve is recognized "…when the anticipated losses, loss adjustment expenses, and maintenance costs exceed the recorded unearned premium reserve and any future installment premiums on existing policies." Because the Industrial Insurance Fund has sufficient anticipated investment income and no unearned premium reserves or installment premium contracts, no premium deficiency reserve is recorded.

#### 1.C.2. Benefit and Claims Administration Liabilities

The Industrial Insurance Fund establishes benefit and claims administration liabilities arising from its workers' compensation coverage based on estimates of the ultimate cost of benefits that have been reported but not resolved and claims that have been incurred but not reported. The length of time for which such costs must be estimated varies depending on the type of benefit involved. Since actual claim costs depend on complex factors such as inflation, changes in doctrines of legal liabilities, claim adjudication, and judgments, the actual ultimate claim costs may differ from the estimates.

Benefit and claims administration liabilities are recomputed quarterly using a variety of actuarial and statistical techniques. These techniques are used to produce current estimates that reflect recent settlements, claim frequency, expected inflation, and other economic, legal, and social factors. A provision for inflation in the calculation of estimated future benefits is implicit in the calculation, because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Future premium income is not offset against benefit liabilities, because benefit liabilities come from coverage periods for which premiums have, in general, already been fully earned. The obligation to pay benefit and claims administration liabilities is not contingent upon any future premiums for future coverage periods.

Adjustments to benefit and claims administration liabilities are charged or credited to benefit and claims administration expense in the periods in which they are made. Unpaid benefits and claims administration expenses include amounts based on past experience for claims development on reported claims and benefits incurred but not reported. Such liabilities are necessarily based on assumptions and estimates, and while management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. The methods for making such estimates and for establishing the resulting liabilities are continually reviewed, and any adjustments are reflected in the period affected.

**1.C.3. Discounting Methodology**

The Industrial Insurance Fund discounts benefit and claims administration expense reserves to reflect the time value of money. The Industrial Insurance Fund uses both tabular and non-tabular discounting. Non-tabular discounting is an accounting practice that departs from SSAP No. 65 as disclosed in 1.B. of this note. The bullets below discuss the discount method and rate applied to each discounted liability category.

- The benefit liabilities in the Pension Reserve Account are discounted on a tabular basis at 6.3 percent.

- Liabilities in the Accident Account for pensions incurred but not-yet-awarded are discounted on both a tabular and non-tabular basis. For each future pension award, the estimated future pension payments are discounted from the anticipated payment dates back to the anticipated date of the pension award on a tabular basis from 4.5 to 6.3 percent. The payments are then discounted from the anticipated date of the pension award back to the evaluation date on a non-tabular basis at 1.5 percent.

- All other Accident and Medical Aid Account benefit and claims administration liabilities are discounted on a non-tabular basis at 1.5 percent.

The discount rate is typically carried at long-term yield rates for risk-free assets, and the investment term is set equal to the average duration of the benefit and claims administration expense payments. Per L&I policy, the non-pension discount rate is equal to the Benchmark Rate less the Risk Adjustment, rounded to the nearest one-half of a percentage point. The Benchmark Rate is the five-year moving average of the U.S. 20-Year Treasury yield. The Risk Adjustment equals two percentage points until the Benchmark Rate reaches 4.0 percent. Below 4.0 percent, the Risk Adjustment is half the Benchmark Rate.

### 1.C.4. Cash and Cash Equivalents

Cash includes cash in banks, cash on deposit with the Office of the State Treasurer (OST), and cash on hand. It also consists of cash equivalents invested by the OST which are short-term, highly-liquid investments that are readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value due to interest rate fluctuations. Under RCW 43.08.015, the OST has the statutory responsibility to ensure the effective cash management of state public funds. RCW 43.84.080 authorizes the Treasurer to invest available cash and includes a list of eligible investments.

The beginning and ending cash and cash equivalent amounts on the Consolidated Statutory Statement of Cash Flows do not include short-term investments. It is not practical to include short-term investments because of the volume of transactions and complexity involved in reporting, as they are managed by the Washington State Investment Board (WSIB), a separate Washington State agency.

### 1.C.5. Investments

The Industrial Insurance Fund uses the following accounting policies to value investments:

- Investment grade bonds are stated at amortized cost using the scientific interest method. Non-investment grade bonds with NAIC designations of 3-6 are stated at the lower of amortized cost or fair value. Fair values are reported using pricing sources approved by the NAIC.

- Short-term investments are stated at amortized cost using the scientific interest method. Per SSAP No. 2, accounting for short-term investments should follow guidance for similar long-term investments (see discussion above on investment grade bonds). Therefore, any short-term bond premiums and discounts are amortized using the scientific interest method.

- Common stocks are stated at fair value.

- Investment grade mortgage-backed and other loan-backed securities are stated at amortized cost. Non-investment grade mortgage-backed and other loan-backed securities with NAIC designations of 3-6 are stated at the lower of amortized cost or fair value. Fair values are reported using pricing sources approved by the NAIC. In compliance with SSAP No. 43R, changes in currently-estimated cash flows are reviewed quarterly using the State Street Corporation's investment valuation model for prepayment assumptions in valuing mortgage-backed and other loan-backed securities. These securities are revalued using the retrospective adjustment method. See Note 3.H. for other-than-temporary impairment analysis of mortgage-backed and other loan-backed securities.
- Securities Lending Collateral - Cash received as collateral on securities lending transactions and investments made with that cash are reported as assets. Securities received as collateral are reported as assets if the Industrial Insurance Fund has the ability to pledge or sell them without a borrower default. Liabilities resulting from these transactions are also reported in the Consolidated Statutory Statement of Admitted Assets, Liabilities, and

Contingency Reserve. Securities lending transactions collateralized by securities that the Industrial Insurance Fund does not have the ability to pledge or sell unless the borrower defaults are not reported as assets or liabilities.

### 1.C.6. Unusual Items and Other Disclosures

The U.S. Department of Energy has contracted with L&I to pay benefits to the Industrial Insurance Fund for workers injured on the job at the Hanford nuclear production complex. The Industrial Insurance Fund has received amounts, including trust cash and trust investments, in advance from the U.S. Department of Energy to cover the pension liability for these injured workers. These amounts are not reported in the financial statements.

As of June 30, 2016, trust cash amounted to $210,003 and is available to reimburse the Industrial Insurance Fund for monthly pension payments. In addition, trust investments totaling $2,477,539 were invested in U.S. Treasury Notes and are also available to reimburse the Industrial Insurance Fund for future expenses. At June 30, 2015, trust cash and trust investment balances were $202,942 and $2,473,560, respectively.

The following tables summarize restricted assets at June 30, 2016 and 2015:

**Restricted Assets**
**June 30, 2016**
(dollars in thousands)

| Restricted Asset Category | Total General Account (G/A) Restricted Assets | Restricted G/A Assets Supporting S/A Activity | Total Separate Account (S/A) Restricted Assets | Restricted S/A Assets Supporting G/A Activity | Total Restricted | Total Assets | % Restricted to Total Assets | Total Admitted Assets | % Restricted to Total Admitted Assets |
|---|---|---|---|---|---|---|---|---|---|
| Collateral held under security lending agreements | $ 114,835 | $ - | $ - | $ - | $ 114,835 | $ 114,835 | 100.00% | $ 15,470,727 | 0.74% |

**Restricted Assets**
**June 30, 2015**
(dollars in thousands)

| Restricted Asset Category | Total General Account (G/A) Restricted Assets | Restricted G/A Assets Supporting S/A Activity | Total Separate Account (S/A) Restricted Assets | Restricted S/A Assets Supporting G/A Activity | Total Restricted | Total Assets | % Restricted to Total Assets | Total Admitted Assets | % Restricted to Total Admitted Assets |
|---|---|---|---|---|---|---|---|---|---|
| Collateral held under security lending agreements | $ 68,406 | $ - | $ - | $ - | $ 68,406 | $ 68,406 | 100.00% | $ 14,820,102 | 0.46% |

The following tables summarize collateral at June 30, 2016 and 2015:

| Collateral<br>June 30, 2016<br>(dollars in thousands) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Restricted Asset Category | Total General Account Collateral | G/A Collateral Supporting S/A Activity | Total Separate Account Collateral | S/A Collateral Supporting G/A Activity | Total Collateral | % Collateral to Total Assets | Total Admitted Assets | % Restricted to Total Admitted Assets |
| Assets received as collateral for security lending agreements | $ 114,835 | $ - | $ - | $ - | $ 114,835 | 100.00% | $ 15,470,727 | 0.74% |
| Liability to return collateral from security lending agreements | $ 114,835 | $ - | $ - | $ - | $ 114,835 | 100.00% | $ 15,470,727 | 0.74% |

| Collateral<br>June 30, 2015<br>(dollars in thousands) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Restricted Asset Category | Total General Account Collateral | G/A Collateral Supporting S/A Activity | Total Separate Account Collateral | S/A Collateral Supporting G/A Activity | Total Collateral | % Collateral to Total Assets | Total Admitted Assets | % Restricted to Total Admitted Assets |
| Assets received as collateral for security lending agreements | $ 68,406 | $ - | $ - | $ - | $ 68,406 | 100.00% | $ 14,820,102 | 0.46% |
| Liability to return collateral from security lending agreements | $ 68,406 | $ - | $ - | $ - | $ 68,406 | 100.00% | $ 14,820,102 | 0.46% |

### 1.C.7. Capital Assets

Capital assets are tangible or intangible assets held and used in the Industrial Insurance Fund operations that have a service life of more than one year and meet the state's capitalization policy. In accordance with the Washington State Office of Financial Management's (OFM) policy, it is the Industrial Insurance Fund's policy to capitalize:

- All land
- Buildings, building improvements, improvements other than buildings, and leasehold improvements with a cost of $100,000 or greater
- All capital assets with a unit cost (including ancillary costs) of $5,000 or greater, unless otherwise noted
- Infrastructure with a cost of $100,000 or greater
- Intangible assets, either purchased or internally developed, with a cost of $1,000,000 or greater, that are "identifiable" by meeting either of the following conditions:
    - The asset is capable of being separated or divided and sold, transferred, licensed, rented, or exchanged; or

  - The asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable.

- All capital assets acquired with a Certificate of Participation

Capital assets are recorded at cost. Capital asset costs include the purchase price plus those costs necessary to place the asset in its intended location and condition for use. Normal maintenance and repair costs that do not materially add to the value or extend the life of capital assets are not capitalized. The cost and related accumulated depreciation of disposed of capital assets are removed from the accounting records.

The value of assets constructed for use in the Industrial Insurance Fund includes all direct construction costs and indirect costs that are related to the construction. Net interest costs incurred during the period of construction, if material, are capitalized.

Depreciation and amortization expenses are calculated using the straight-line method over the estimated useful lives of the assets. Total depreciation and amortization expense for capital assets was $10.2 million and $7.2 million at June 30, 2016 and 2015, respectively.

Generally, estimated useful lives are as follows:

| | |
|---|---|
| • Buildings and building components | 5 to 50 years |
| • Furnishings, equipment, and collections | 3 to 50 years |
| • Other improvements | 3 to 50 years |
| • Infrastructure | 20 to 50 years |
| • Intangible assets with definite useful lives | 3 to 50 years |

In accordance with SAP, not all capitalized assets are admitted for reporting purposes. Common examples of nonadmitted capital assets are equipment, furniture, and internally developed software. These nonadmitted assets are adjusted from the respective account's contingency reserve, and current purchases are immediately expensed. SSAP No. 16 allows electronic data processing (EDP) equipment and operating system software to be admitted, up to three percent of the contingency reserve. However, the Industrial Insurance Fund takes a more conservative approach and does not admit any EDP equipment or operating system software.

**1.C.8. Risk Management**

The state of Washington operates a self-insurance liability program pursuant to RCW 4.92.130. The state's policy is generally not to purchase commercial insurance for the risk of losses to which it is exposed. Instead, the state's management believes it is more economical to manage its risks internally and set aside assets for claims settlement in the Risk Management Fund, an internal service fund. Commercial insurance is purchased for certain liabilities and to limit the exposure to catastrophic losses. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past ten fiscal years. Otherwise, the self-insurance liability program services all claims against the state for injuries and property damage to third parties.

The Industrial Insurance Fund participates in the state's self-insurance liability program, in proportion to its anticipated exposure to liability losses, to manage its various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; and natural disasters.

## Note 2 - Accounting and Reporting Changes

### Reclassifications

Certain reclassifications of amounts previously reported have been made to the accompanying financial statements to maintain consistency between periods presented. Prior to fiscal year 2016, claims administration expenses incurred were calculated by adding claims administration expenses paid to the change in claims administration expense liabilities. Any excess accrued administration expenses were reported as a nonadmitted asset. Beginning in fiscal year 2016, L&I decided to change the method for reporting nonadmitted assets to be more consistent with the insurance industry. The accrued administration expenses are now recorded as claim administration expenses, and no adjustments are made on the balance sheet.

The reclassification was made in accordance with SSAP No. 3 *Accounting Changes and Correction of Errors*. The cumulative effect was a $3,582,000 decrease in contingency reserve as of July 1, 2015 , as shown in the table below. The total liabilities at July 1, 2015, increased by the same amount. This change has no impact on net income or total admitted assets in the 2016 and 2015 fiscal years.

**Change in Nonadmitted Assets**

| | June 30, 2016 | June 30, 2015 |
|---|---|---|
| Contingency reserve at June 30, 2015 and 2014, as previously reported | $ 1,225,142,000 | $ 949,521,000 |
| Cumulative effect of change in accounting principles - Change in Nonadmitted Assets | (3,582,000) | (3,582,000) |
| Contingency reserve at July 1, 2015 and 2014, as reclassified | $ 1,221,560,000 | $ 945,939,000 |
| | | |
| Total liabilities at June 30, 2016 and 2015, as previously reported | $ 13,977,805,000 | $13,594,960,000 |
| Cumulative effect of change in accounting principles - Change in Nonadmitted Assets* | - | 3,582,000 |
| Total liabilities at June 30, 2016 and 2015, as reclassified | $ 13,977,805,000 | $13,598,542,000 |

* Change reflected in other liabilities on the Statement of Admitted Assets, Liabilities, and Contingency Reserve

### Change in Estimate

Prior to fiscal year 2016, the liability for one of the self-insured employer's pensions was estimated on a cash-funded basis. Cash-funded pensions are included in the pension benefit liability estimate, because the agency has the fiduciary responsibility to pay these benefits. In September of fiscal year 2016, new information was obtained that changed the basis upon which the estimates were formed from cash-funded to bonded. The pension liabilities associated with bonded pensions are not included in the agency's pension benefit liabilities, because the employer is guaranteeing the payment. As a result, the claims payable liability estimate as of June 30, 2016, was reduced by $24,129,000, which decreased claims expense and decreased the net position deficit by the same amount.

## Note 3 - Investments

### 3.A. Summary of Investment Policies

Under RCW 43.33A.030, trusteeship over the Industrial Insurance Fund's investments is vested in the voting members of the WSIB. The legislature established a standard of care for investment of these funds in RCW 43.33A.140. Additionally, the WSIB and its staff must comply with other state laws, such as the Ethics in Public Service Act, chapter 42.52 RCW, as it makes investment decisions and seeks to meet its investment objectives.

In accordance with RCW 43.33A.110, Industrial Insurance Fund investments are to be managed to limit fluctuations in the industrial insurance premiums and, subject to this purpose, achieve a maximum return at a prudent level of risk. Based on this requirement, the strategic objectives are to:

- Maintain the solvency of the accounts.
- Maintain premium rate stability.
- Ensure sufficient assets are available to fund the expected liability payments.
- Subject to the objectives above, achieve a maximum return at a prudent level of risk.

Performance objectives are intended to provide the WSIB and the Industrial Insurance Fund with a way to measure the success of this investment policy, the overall asset allocation strategy, and the implementation of that strategy over time. First and foremost, the performance of the investment portfolios shall be judged relative to the strategic objectives. With the first three criteria met, the actual rates of return of the portfolios will be compared to the Comparable Market Index (CMI) for each account. The CMIs are developed and calculated with the goal to construct a hypothetical passive portfolio, with the duration, asset allocation, and appropriate mix of fixed income sectors based on the individual targets for each Industrial Insurance Fund account. The return for each account's portfolio should not be significantly different from that of its CMI over the long-term.

**Eligible Investments -** Eligible investments are securities and deposits that are in accordance with the Industrial Insurance Fund's investment policy and chapter 43.33A RCW. Eligible investments include:

- U.S. equities.
- International equities.
- U.S. Treasuries and government agencies.
- Credit bonds.
- Mortgage-backed securities rated investment grade, as defined by Barclays Capital Global Family of Fixed Income Indices.
- Asset-backed securities rated investment grade, as defined by Barclays Capital Global Family of Fixed Income Indices.
- Commercial mortgage-backed securities rated investment grade, as defined by Barclays Capital Global Family of Fixed Income Indices.
- Investment grade non-U.S. dollar bonds.

**Investment Restrictions -** To meet stated objectives, investments of the Industrial Insurance Fund are subject to the following constraints:

- All assets under the management of the WSIB are to be invested to maximize return at a prudent level of risk, in accordance with RCW 43.33A.110 and RCW 43.33A.140.
- Asset allocations will be reviewed every three to four years or sooner if there are significant changes in funding levels or the liability durations.
- Assets will be rebalanced across asset classes when the fair value of the assets falls outside the policy ranges. The timing of any rebalancing will be based on market opportunities, cash flows, and the consideration of transaction costs; therefore, they need not occur immediately.
- Sector allocation for U.S. equities should be within a range of 55 to 65 percent. Allocation for international equities should be within a range of 35 to 45 percent.
- No corporate fixed income issue cost shall exceed 3 percent of the Fund's fair value at the time of purchase, nor shall its fair value exceed 6 percent of the Fund's fair value at any time. This rule applies to any specific corporate bond relative to all of the Fund's assets in aggregate, across all accounts and all their asset class holdings.
- The benchmark and structure for U.S. equities will be the broad U.S. stock market as defined by the Morgan Stanley Capital International (MSCI) U.S. Investable Market Index.

The benchmark and structure for international equities will be the MSCI All Country World Ex U.S. Investable Market Index. Both portfolios will be 100 percent passively managed in commingled index funds. The commingled funds may use futures for hedging or establishing a long position.

- The fixed income portfolios' structures vary depending upon the required duration target. The duration targets will be reviewed every three years or sooner if there are significant changes in the funding levels or the liability durations.

- Sector allocation of fixed income investments must be managed within the following prescribed ranges:

| | |
|---|---|
| ▪ U.S. Treasuries and government agencies | 5 to 25 percent |
| ▪ Credit bonds | 20 to 80 percent |
| ▪ Asset-backed securities | 0 to 10 percent |
| ▪ Commercial mortgage-backed securities | 0 to 10 percent |
| ▪ Mortgage-backed securities | 0 to 25 percent |

  These targets are long-term in nature. Deviations may occur in the short-term as a result of interim market conditions; however, if a range is exceeded, the portfolios must be rebalanced to the target allocations as soon as it is practical.

- Total market value of below-investment-grade credit bonds, as defined by Barclays Capital Global Family of Fixed Income Indices, shall not exceed 5 percent of the total market value of the funds. Although below-investment-grade mortgage-backed, asset-backed, and commercial mortgage-backed securities may not be purchased, portfolio holdings that are downgraded to those levels or are no longer rated may continue to be held. Total market value of below-investment-grade mortgage-backed, asset-backed and commercial-mortgage-backed securities shall not exceed 5 percent of total market value of the funds.

### 3.B. Interest Rate Risk

Interest rate risk is the risk that changes in interest rates over time will adversely affect the fair value of an investment. The risk is managed within the portfolios using effective duration, which is the measure of a debt investment's exposure to fair value changes arising from changes in interest rates. Increases in prevailing interest rates generally translate into decreases in fair values of fixed income investments. The Industrial Insurance Fund does not have a formal policy specifically for interest rate risk.

As of June 30, 2016, the Industrial Insurance Fund's portfolio was within the duration targets below:

- Accident Account – within plus or minus 20 percent of an effective duration target of seven years

- Medical Aid Account – within plus or minus 20 percent of an effective duration target of six years

- Pension Reserve Account – within plus or minus 20 percent of an effective duration target of seven years

It is the goal of the fixed income portfolios to match the target durations. Although there may be differences from the targets due to market conditions, over any extended period of time, those differences should not be material.

### 3.C. Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Industrial Insurance Fund's investment policies limit the fixed income securities to investment grade or higher at the time of purchase. Investment grade securities are those fixed income securities with a Moody's rating of Aaa to Baa or a Standard and Poor's rating of AAA to BBB. The rated debt investments of the Industrial Insurance Fund as of June 30, 2016, were rated by Moody's and/or an equivalent national rating organization.

**Concentration of Credit Risk -** Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. The Industrial Insurance Fund's policy states that the corporate fixed income issues cost shall not exceed 3 percent of the Fund's fair value at the time of purchase, nor shall its fair value exceed 6 percent of the Fund's fair value at any time. There was no concentration of credit risk as of June 30, 2016.

**Custodial Credit Risk -** Custodial credit risk is the risk that in the event a depository institution or counterparty fails, the Industrial Insurance Fund would not be able to recover the value of its deposits, investments, or collateral securities. As of June 30, 2016, investment securities (excluding cash, cash equivalents and repurchase agreements held as securities lending collateral) are registered and held in the name of the WSIB for the benefit of the Industrial Insurance Fund and are not exposed to custodial credit risk. There are no general policies relating to custodial credit risk.

### 3.D. Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. The Industrial Insurance Fund does not have a formal policy to limit foreign currency risk. The Industrial Insurance Fund had $671.6 million and $695.0 million invested in an international commingled equity index fund at June 30, 2016 and 2015, respectively. As such, no currency denomination risk is present at June 30, 2016.

### 3.E. Derivatives

To manage its exposure to fluctuations in interest and currency rates while increasing portfolio returns, the Industrial Insurance Fund is authorized to utilize various derivative financial instruments, including collateralized mortgage obligations, financial futures, forward contracts, interest rate and equity swaps, and options.

Derivative transactions involve, to varying degrees, market and credit risk. The Industrial Insurance Fund mitigates market risks arising from derivative transactions by requiring collateral in cash and investments to be maintained in an amount equal to the securities positions outstanding and, thereby, prohibiting the use of leverage or speculation. Credit risks arising from derivative transactions are mitigated by selecting and monitoring creditworthy counterparties and collateral issuers.

Domestic and foreign passive equity index fund managers may also utilize various derivative securities to manage exposure to risk and increase portfolio returns. Information on the extent of use and holdings of derivative securities by passive equity index fund managers is unavailable. The only derivative securities held directly by the Industrial Insurance Fund were collateralized mortgage obligations (CMOs) of $922.5 million and $1.30 billion at June 30, 2016 and 2015, respectively.

### 3.F. Reverse Repurchase Agreements

State law permits the Industrial Insurance Fund to enter into reverse repurchase agreements, i.e., a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The fair value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in fair value of the securities. If the dealers default on their obligations to resell these securities to the state or provide securities or cash of equal value, the Industrial Insurance Fund would suffer an economic loss equal to the difference between the fair value, plus accrued interest, of the underlying securities and the agreement obligation, including accrued interest. There were no reverse repurchase agreements during fiscal year 2016 or 2015, and there were no liabilities outstanding as of June 30, 2016 or 2015.

### 3.G. Wash Sales Transactions

Wash sales are any transfers that occur when an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security. These transactions involve unrated securities or those with NAIC designations of 3 or below. There were no wash sale transactions in the Industrial Insurance Fund during fiscal year 2016 or 2015.

### 3.H. Bonds

At June 30, 2016 and 2015, bonds were comprised of U.S. government, other governments, corporate, mortgage-backed, and other loan-backed securities, with an aggregate book adjusted carrying value (BACV) of $12,665,856,000 and $12,008,655,000 and fair value of

$13,561,443,000 and $12,502,439,000, respectively, as shown in the following tables:

**Book Adjusted Carrying Values and Fair Values**
**June 30, 2016**
(in thousands)

| | Book Adjusted Carrying Value | Fair Value Excess over BACV | BACV Excess over Fair Value | Fair Value |
|---|---|---|---|---|
| U.S. government obligations - excluding mortgage-backed securities | $ 2,008,377 | $ 99,474 | $ (42) | $ 2,107,809 |
| All other government obligations | 1,205,391 | 63,623 | (1,341) | 1,267,673 |
| Mortgage-backed and other loan-backed securities | 1,359,978 | 99,818 | (804) | 1,458,992 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 7,978,367 | 681,828 | (50,176) | 8,610,019 |
| Hybrid securities | 113,743 | 3,207 | - | 116,950 |
| **Total** | $ 12,665,856 | $ 947,950 | $ (52,363) | $ 13,561,443 |

**Book Adjusted Carrying Values and Fair Values**
**June 30, 2015**
(in thousands)

| | Book Adjusted Carrying Value | Fair Value Excess over BACV | BACV Excess over Fair Value | Fair Value |
|---|---|---|---|---|
| U.S. government obligations - excluding mortgage-backed securities | $ 1,165,527 | $ 5,116 | $ (11,937) | $ 1,158,705 |
| All other government obligations | 1,300,556 | 59,458 | (14,762) | 1,345,252 |
| Mortgage-backed and other loan-backed securities | 1,800,133 | 127,225 | (3,424) | 1,923,934 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 7,637,471 | 432,925 | (103,362) | 7,967,035 |
| Hybrid securities | 104,968 | 3,036 | (491) | 107,513 |
| **Total** | $ 12,008,655 | $ 627,760 | $ (133,976) | $ 12,502,439 |

The following tables present the Industrial Insurance Fund's bond investments by type and by stated contractual maturity in years, and provide the BACV and fair value of bonds as of June 30, 2016 and 2015. Expected maturities may differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

**Schedule of Maturities**
**June 30, 2016**
(in thousands)

| | | | Maturity | | | |
|---|---|---|---|---|---|---|
| **Investment Type** | **Fair Value** | **Book Adjusted Carrying Value** | **1 year or less** | **Over 1 year through 5 years** | **Over 5 years through 10 years** | **Over 10 years** |
| U.S. government obligations - excluding mortgage-backed securities | $ 2,107,809 | $ 2,008,377 | $ 79,939 | $ 699,130 | $ 694,100 | $ 535,208 |
| All other government obligations | 1,267,673 | 1,205,391 | 233,968 | 459,761 | 344,827 | 166,835 |
| Mortgage-backed and other loan-backed securities | 1,458,992 | 1,359,978 | 3 | 177,102 | 42,608 | 1,140,265 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 8,610,019 | 7,978,367 | 935,032 | 1,926,473 | 2,290,732 | 2,826,130 |
| Hybrid securities | 116,950 | 113,743 | - | 45,016 | 68,727 | - |
| **Total** | $ 13,561,443 | $ 12,665,856 | $ 1,248,942 | $ 3,307,482 | $ 3,440,994 | $ 4,668,438 |

| Schedule of Maturities June 30, 2015 (in thousands) | | | | | | |
|---|---|---|---|---|---|---|
| | | | Maturity | | | |
| Investment Type | Fair Value | Book Adjusted Carrying Value | 1 year or less | Over 1 year through 5 years | Over 5 years through 10 years | Over 10 years |
| U.S. government obligations - excluding mortgage-backed securities | $ 1,158,705 | $ 1,165,527 | $ - | $ 818,655 | $ 54,933 | $ 291,939 |
| All other government obligations | 1,345,252 | 1,300,556 | 163,932 | 510,500 | 357,645 | 268,478 |
| Mortgage-backed and other loan-backed securities | 1,923,934 | 1,800,133 | 20,953 | 189,619 | 83,253 | 1,506,308 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 7,967,035 | 7,637,471 | 306,456 | 2,519,104 | 1,944,262 | 2,867,649 |
| Hybrid securities | 107,513 | 104,968 | - | 4,988 | 99,981 | - |
| **Total** | $ 12,502,439 | $ 12,008,655 | $ 491,342 | $ 4,042,866 | $ 2,540,073 | $ 4,934,374 |

The following additional tables are included to summarize the different classes of investments held by the Industrial Insurance Fund as they are rated by the NAIC. There were no securities with an NAIC designation higher than 4 at the fiscal years ended June 30, 2016 and 2015.

| Fair Value of Securities by NAIC Designation June 30, 2016 (in thousands) | | | | | |
|---|---|---|---|---|---|
| | NAIC Designation | | | | |
| | 1 | 2 | 3 | 4 | Total |
| U.S. government obligations - excluding mortgage-backed securities | $ 2,107,809 | $ - | $ - | $ - | $ 2,107,809 |
| All other government obligations | 1,061,957 | 154,588 | 24,597 | 26,531 | 1,267,673 |
| Mortgage-backed and other loan-backed securities | 1,458,992 | - | - | - | 1,458,992 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 5,105,419 | 3,177,066 | 179,341 | 148,193 | 8,610,019 |
| Hybrid securities | 10,174 | 9,510 | 92,399 | 4,867 | 116,950 |
| **Total** | $ 9,744,351 | $ 3,341,164 | $ 296,337 | $ 179,591 | $ 13,561,443 |

| Fair Value of Securities by NAIC Designation June 30, 2015 (in thousands) | | | | | |
|---|---|---|---|---|---|
| | NAIC Designation | | | | |
| | 1 | 2 | 3 | 4 | Total |
| U.S. government obligations - excluding mortgage-backed securities | $ 1,158,705 | $ - | $ - | $ - | $ 1,158,705 |
| All other government obligations | 1,111,220 | 225,644 | 8,388 | - | 1,345,252 |
| Mortgage-backed and other loan-backed securities | 1,923,934 | - | - | - | 1,923,934 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 4,627,784 | 3,256,155 | 83,096 | - | 7,967,035 |
| Hybrid securities | 20,304 | 82,304 | 4,905 | - | 107,513 |
| **Total** | $ 8,841,947 | $ 3,564,103 | $ 96,389 | $ - | $ 12,502,439 |

Gross unrealized losses on bonds, the fair value of the related bonds aggregated by investment category, and length of time that individual bonds have been in a continuous unrealized loss position at June 30, 2016 and 2015, were as follows:

**Bonds with Unrealized Losses**
**June 30, 2016**
(in thousands)

| | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | **Fair value** | **Unrealized Losses** | **Fair value** | **Unrealized Losses** | **Fair value** | **Unrealized Losses** |
| U.S. government obligations - excluding mortgage-backed securities | $ 20,811 | $ (42) | $ - | $ - | $ 20,811 | $ (42) |
| All other government obligations | 9,020 | (109) | 120,065 | (14,585) | 129,085 | (14,694) |
| Mortgage-backed and other loan-backed securities | 12,223 | (19) | 30,403 | (756) | 42,626 | (775) |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 79,593 | (2,648) | 735,613 | (117,384) | 815,206 | (120,032) |
| Hybrid securities | - | - | 24,766 | (201) | 24,766 | (201) |
| **Total** | $ 121,647 | $ (2,818) | $ 910,847 | $ (132,926) | $ 1,032,494 | $ (135,744) |

**Bonds with Unrealized Losses**
**June 30, 2015**
(in thousands)

| | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | **Fair value** | **Unrealized Losses** | **Fair value** | **Unrealized Losses** | **Fair value** | **Unrealized Losses** |
| U.S. government obligations - excluding mortgage-backed securities | $ 246,216 | $ (7,187) | $ 488,603 | $ (4,914) | $ 734,819 | $ (12,101) |
| All other government obligations | 91,710 | (3,693) | 131,960 | (12,522) | 223,670 | (16,215) |
| Mortgage-backed and other loan-backed securities | 120,453 | (831) | 68,442 | (2,117) | 188,895 | (2,948) |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 2,213,231 | (86,207) | 331,914 | (24,494) | 2,545,145 | (110,701) |
| Hybrid securities | 24,426 | (537) | - | - | 24,426 | (537) |
| **Total** | $ 2,696,036 | $ (98,455) | $ 1,020,919 | $ (44,047) | $ 3,716,955 | $ (142,502) |

In compliance with SSAP No. 26, management has looked at all bonds in an unrealized loss position and used several categories of information to determine whether any impairment is other-than-temporary. The information considered included general market conditions, industry or company financial prospects, an issuer's fundamental credit difficulties, and the length of time and the extent to which the fair value had been below cost. Management has no intention of selling these securities and does not believe these impairments are other-than-temporary.

Similarly, in compliance with SSAP No. 43R, management has looked at mortgage-backed and other loan-backed securities with unrealized losses and has used several categories of information to determine whether any impairment is other-than-temporary. State Street Corporation's investment valuation model for prepayment assumptions and determining currently estimated cash flows in valuing mortgage-backed and other loan-backed securities was used. The factors that are considered include discounted cash flow on an investment, the length of time and amount of impairment, forecasts, market data, and financial condition of the issuer(s). As of June 30, 2016, no mortgage-backed or other loan-backed securities have been determined to be other-than-temporarily impaired.

The following tables summarize realized gains or losses of bonds that were redeemed or sold during fiscal years 2016 and 2015:

**Bonds Redeemed or Sold**
**June 30, 2016**
(in thousands)

| | Sales Proceeds | Realized Gains | Realized Losses | Net Realized Gains (Losses) |
|---|---|---|---|---|
| U.S. government obligations - excluding mortgage-backed securities | $ 175,472 | $ 137 | $ (294) | $ (157) |
| All other government obligations | 320,193 | 15,700 | - | 15,700 |
| Mortgage-backed securities | 393,998 | 19,046 | - | 19,046 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 1,188,278 | 32,320 | (3,460) | 28,860 |
| Hybrid securities | 1,034 | 42 | - | 42 |
| **Total** | $ 2,078,975 | $ 67,245 | $ (3,754) | $ 63,491 |

**Bonds Redeemed or Sold**
**June 30, 2015**
(in thousands)

| | Sales Proceeds | Realized Gains | Realized Losses | Net Realized Gains (Losses) |
|---|---|---|---|---|
| U.S. government obligations - excluding mortgage-backed securities | $ 333,494 | $ 2,238 | $ (71) | $ 2,167 |
| All other government obligations | 229,635 | 8,743 | - | 8,743 |
| Mortgage-backed securities | 223,574 | - | - | - |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 541,775 | 29,831 | (168) | 29,663 |
| Hybrid securities | - | - | - | - |
| **Total** | $ 1,328,478 | $ 40,812 | $ (239) | $ 40,573 |

In compliance with SSAP No. 26, paragraph 20.l, the following tables show the details of the structured notes held by the Industrial Insurance Fund at June 30, 2016 and 2015:

**Structured Notes**
June 30, 2016
(in thousands)

| CUSIP Identification | Actual Cost | Fair Value | Book/Adjusted Carry Value | Mortgage-Referenced Security (Y/N) |
|---|---|---|---|---|
| 064159CR5 | $ 20,000 | $ 20,003 | $ 20,000 | N |
| 136069FV8 | 25,000 | 25,007 | 25,000 | N |
| 172967GV7 | 20,000 | 20,009 | 20,000 | N |
| 63254AAH1 | 10,000 | 10,005 | 10,000 | N |
| **Total** | $ 75,000 | $ 75,024 | $ 75,000 | |

| Structured Notes<br>June 30, 2015<br>(in thousands) | | | | |
|---|---|---|---|---|
| CUSIP Identification | Actual Cost | Fair Value | Book/Adjusted Carry Value | Mortgage-Referenced Security (Y/N) |
| 064159CR5 | $ 20,000 | $ 20,076 | $ 20,000 | N |
| 136069FV8 | 25,000 | 25,088 | 25,000 | N |
| 172967GV7 | 20,000 | 20,057 | 20,000 | N |
| 63254AAH1 | 10,000 | 10,049 | 10,000 | N |
| 045167CL5 | 25,000 | 24,996 | 25,000 | N |
| **Total** | $ 100,000 | $ 100,266 | $ 100,000 | |

### 3.I. Common Stocks

The gross unrealized losses on common stocks, fair value of the common stocks, and length of time that individual common stocks had been in a continuous unrealized loss position, at June 30, 2016 and 2015, were as follows:

**Common Stocks with Unrealized Losses**
**June 30, 2016**
(in thousands)

| | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | Fair value | Unrealized Losses | Fair value | Unrealized Losses | Fair value | Unrealized Losses |
| Commingled index funds | $ 173,361 | $ (11,196) | $ 99,148 | $ (22,710) | $ 272,509 | $ (33,906) |
| **Total** | $ 173,361 | $ (11,196) | $ 99,148 | $ (22,710) | $ 272,509 | $ (33,906) |

**Common Stocks with Unrealized Losses**
**June 30, 2015**
(in thousands)

| | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | Fair value | Unrealized Losses | Fair value | Unrealized Losses | Fair value | Unrealized Losses |
| Commingled index funds | $ 145,009 | $ (6,219) | $ 36,059 | $ (5,651) | $ 181,068 | $ (11,870) |
| **Total** | $ 145,009 | $ (6,219) | $ 36,059 | $ (5,651) | $ 181,068 | $ (11,870) |

In compliance with SSAP No. 30, management has looked at all commingled index funds in an unrealized loss position and used several categories of information to determine whether any impairment is other-than-temporary. The information considered for broad equity funds included general market conditions and prospects for the economy as a whole in the short term. Management has no intention of selling these commingled index funds and does not believe these impairments are other-than-temporary.

### 3.J. Fair Value Measurements

The Industrial Insurance Fund has categorized its investments that are reported on the Consolidated Statutory Statement of Admitted Assets, Liabilities, and Contingency Reserve at fair value into a three-level hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The three-level hierarchy is based on the degree of subjectivity inherent in the valuation method by which fair value was determined. The three levels are defined as follows:

- Level 1 - Quoted prices in active markets for identical assets or liabilities

- Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that can be corroborated by observable market data for substantially the full term of the assets or liabilities

- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

The asset's or liability's fair value measurement level within the hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.
The following is a description of the valuation methodologies used for assets measured at fair value:

- Industrial and miscellaneous bonds - value is based on market values approved by the NAIC

- Equities – value is based on the underlying equity

- Other invested assets – value is based on the underlying equity

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of the future fair values. The Industrial Insurance Fund has determined that its valuation methods are appropriate and consistent with other market participants; however, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The following tables present the financial instruments related to the Fund's assets carried at fair value as of June 30, 2016 and 2015, by the SSAP No. 100 valuation hierarchy:

**Investment Assets Carried at Fair Value**
**June 30, 2016**
(in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Fixed income | $ - | $ 419,605 | $ - | $ 419,605 |
| Equities | - | 1,766,364 | - | 1,766,364 |
| **Total** | $ - | $ 2,185,969 | $ - | $ 2,185,969 |

**Investment Assets Carried at Fair Value**
**June 30, 2015**
(in thousands)

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Fixed income | $ - | $ 95,696 | $ - | $ 95,696 |
| Equities | - | 1,895,746 | - | 1,895,746 |
| **Total** | $ - | $ 1,991,442 | $ - | $ 1,991,442 |

Only bonds with an NAIC designation of 3-6 and a fair value lower than the book adjusted value are carried at fair value on the financial statements. On June 30, 2016, there were thirty-six bonds in this category, with fair values totaling $419,605,191. On June 30, 2015, there were nine bonds in this category, with fair values totaling $95,696,266.

At the end of each reporting period, the Industrial Insurance Fund evaluates whether or not any event has occurred or circumstances have changed that would cause an instrument to be transferred between Levels 1 and 2. This policy also applies to transfers into or out of Level 3. During the current year, no transfers between Levels 1, 2 or 3 were required.

The fair values of bonds categorized as Level 2 were valued using a market approach. These valuations were determined to be Level 2 valuations, as quoted markets prices for similar instruments in an active market were utilized. This was accomplished by the use of matrix pricing. Matrix pricing takes quoted prices of bonds with similar features and applies analytic methods to determine the fair value of bonds held.

The following tables reflect the fair values and admitted values of all admitted assets and liabilities. The fair values are also categorized into the three-level fair value hierarchy as described above.

**Investment Assets at Fair Value**
**June 30, 2016**
(in thousands)

| | Fair Value | Admitted Value | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|---|---|
| Fixed income | $ 13,561,443 | $ 12,665,856 | $ - | $ 13,561,443 | $ - | $ 13,561,443 |
| Equities | 1,766,364 | 1,766,364 | - | 1,766,364 | - | 1,766,364 |
| Short-term investments | 161,305 | 161,305 | - | 161,305 | - | 161,305 |
| **Total** | $ 15,489,112 | $ 14,593,525 | $ - | $ 15,489,112 | $ - | $ 15,489,112 |

| Investment Assets at Fair Value<br>June 30, 2015<br>(in thousands) | | | | | | |
|---|---|---|---|---|---|---|
| | Fair Value | Admitted Value | Level 1 | Level 2 | Level 3 | Total |
| Fixed income | $ 12,502,439 | $ 12,008,655 | $ - | $ 12,502,439 | $ - | $ 12,502,439 |
| Equities | 1,895,746 | 1,895,746 | - | 1,895,746 | - | 1,895,746 |
| Short-term investments | 108,857 | 108,857 | - | 108,857 | - | 108,857 |
| **Total** | $ 14,507,042 | $ 14,013,258 | $ - | $ 14,507,042 | $ - | $ 14,507,042 |

## Note 4 - Real Estate and Improvements

At June 30, 2016 and 2015, the Accident and Medical Aid Accounts admitted only land, buildings, and improvements, net of accumulated depreciation and encumbrances.

SSAP No. 40R requires that buildings more than 50 percent occupied by the reporting entity be categorized as a real estate investment and that depreciation and interest expense be classified as investment expenses. The building occupied by the Industrial Insurance Fund's employees is financed through general obligation bonds of the state of Washington. The remaining balance due on the bonds was paid October 1, 2015. Due to indirect ownership by the state of Washington, the land, building, and improvements are not shown as a real estate investment of the Industrial Insurance Fund. The related depreciation and interest expenses are allocated between administrative and non-insurance expenses based on percentage of use by employees.

| Real Estate and Improvements<br>(in thousands) | | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |
| Land | $ 3,204 | $ 3,204 |
| Building occupied by Industrial Insurance Fund | 65,134 | 65,134 |
| Improvements, other than buildings | 1,020 | 1,020 |
| Encumbrances | - | (4,050) |
| Accumulated depreciation - building | (31,702) | (30,348) |
| Accumulated depreciation - improvements | (479) | (459) |
| **Total** | $ 37,177 | $ 34,501 |

## Note 5 - Investment Income

The Industrial Insurance Fund does not admit investment income due and accrued if amounts are over 90 days past due. As of June 30, 2016 and 2015, all investment income due and accrued was admitted, with balances accrued by security type, as summarized in the following table:

**Interest Income Admitted Due and Accrued**
(in thousands)

| | June 30, 2016 | June 30, 2015 |
|---|---|---|
| U.S. government obligations - excluding mortgage-backed securities | $ 7,618 | $ 4,133 |
| All other government obligations | 10,966 | 13,461 |
| Mortgage-backed and other loan-backed securities | 5,005 | 8,066 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 84,395 | 84,641 |
| Hybrid securities | 1,841 | 1,719 |
| Other interest | 46 | 1 |
| **Total** | $ 109,871 | $ 112,021 |

The following table provides details for net investment income by security type for the fiscal years ended June 30, 2016 and 2015:

**Net Investment Income Earned**
(in thousands)

| | June 30, 2016 | June 30, 2015 |
|---|---|---|
| U.S. government obligations - excluding mortgage-backed securities | $ 27,073 | $ 15,634 |
| All other government obligations | 40,760 | 46,238 |
| Mortgage-backed and other loan-backed securities | 64,311 | 83,036 |
| Industrial and miscellaneous - excluding mortgage-backed and other loan-backed securities | 357,937 | 339,098 |
| Hybrid securities | 5,502 | 5,502 |
| **Total Bond Interest** | 495,583 | 489,508 |
| Equities dividends | 1,363 | 2,269 |
| Net securities lending income | 9 | (182) |
| Other interest and litigation income | 629 | 571 |
| Amortization | 5,446 | 5,461 |
| Gross investment income | 503,030 | 497,627 |
| Investment expenses | (4,531) | (4,219) |
| **Total Net Investment Income Earned** | $ 498,499 | $ 493,408 |

## Note 6 - Retirement Plans, Compensated Absences, Deferred Compensation Plan, and Other Postemployment Benefits

### 6.A. Retirement Plans

The Industrial Insurance Fund is administered by L&I, an agency of the state of Washington and part of the primary government. Industrial Insurance Fund employees participate in the Washington State Public Employees' Retirement System (PERS), administered by the Washington State Department of Retirement Systems (DRS).

The PERS is a multiemployer retirement system comprised of three separate plans for membership purposes: Plans 1 and 2 are defined benefit plans, and Plan 3 is a combination defined benefit/defined contribution plan. PERS participants who joined the system by September 30, 1977, are Plan 1 members. Those who joined on or after October 1, 1977, and by February 28, 2002, are Plan 2 members, unless they exercised an option to transfer their membership to Plan 3. PERS participants joining the system on or after March 1, 2002, have the irrevocable option of choosing membership in either Plan 2 or Plan 3.

PERS defined benefit retirement benefits are financed from a combination of investment earnings and employer and employee contributions. Under the PERS rules, the employee and employer each contribute a percentage of the employee's compensation.

Each biennium, the state Pension Funding Council adopts Plan 1 employer contribution rates, Plan 2 employer and employee contribution rates, and Plan 3 employer contribution rates. Contribution requirements are established and amended by state statute. All employers are required to contribute at the level established by the legislature. The methods used to determine the contribution requirements are established under state statute in accordance with chapters 41.40 and 41.45 RCW.

The employer contribution rates for the Industrial Insurance Fund at June 30, 2016 and 2015, for each of Plans 1, 2, and 3 were 11.18 and 9.21 percent of the employee's annual covered salary, respectively. The Industrial Insurance Fund contributed $17,823,173 and $13,991,371 to the PERS during the fiscal years ended June 30, 2016 and 2015, respectively. The Industrial Insurance Fund's contribution was 1.5 percent of total employer contributions to the plans in fiscal years ended June 30, 2016 and 2015. The employer contribution rate from July 1, 2016, through June 30, 2017, has already been established by the legislature to be 11.18 percent for each of Plans 1, 2, and 3.

Employee contribution rates for Plan 1 are established by statute at 6 percent for state agencies employees. Contributions for Plan 2 members are determined by the aggregate method and may vary over time. The contribution rate for Plan 2 state agency employees for fiscal years ended June 30, 2016 and 2015, was 6.12 percent of the employee's annual covered salary. Under Plan 3, employer contributions finance the defined benefit portion of the plan, and member contributions finance the defined contribution portion. The Director of the DRS sets Plan 3 employee contribution rate options. Members can choose from six rate options ranging from 5 to 15 percent. Two of the options are graduated rates dependent on the employee's age.

The Industrial Insurance Fund's proportionate share of the collective pension liability for fiscal year ended June 30, 2016, was $124,027,174 for the plans in which its employees participate. The proportion is based on the Industrial Insurance Fund's contributions relative to the contributions of all participating employers. In accordance with SSAP No. 102, the unfunded status of the pension plan is not required to be recognized because it is considered a multiemployer plan, therefore it has not been accrued in the State Fund's financials.

Additional information regarding the PERS may be obtained from the stand-alone financial report prepared by the DRS. A copy of the report may be obtained by contacting the Washington State Department of Retirement Systems, P.O. Box 48380, Olympia, WA 98504-8380 or online at http://www.drs.wa.gov/administration/annual-report.

### 6.B. Compensated Absences

Industrial Insurance Fund employees accrue vested annual leave at a variable rate based on years of service. In general, accrued annual leave cannot exceed 240 hours at the employee's anniversary date.

Employees accrue sick leave at the rate of one day per month without limitation on the amount that can be accumulated. Sick leave is not vested; i.e., the Industrial Insurance Fund does not pay employees for unused sick leave upon termination except upon employee death or retirement, at which time the Industrial Insurance Fund is liable for 25 percent of the employee's accumulated sick leave. In addition, the Industrial Insurance Fund has a "sick leave buyout option" in which, each January, employees who have accumulated sick leave in excess of 480 hours may redeem sick leave earned but not taken during the previous year at the rate of one day's pay in exchange for each four days of sick leave.

It is the Industrial Insurance Fund's policy to liquidate unpaid compensated absence balances outstanding at June 30 with future resources, rather than advance funding it with currently available expendable financial resources.

The Industrial Insurance Fund recognizes the expense and accrues a liability for annual leave and estimated sick leave buyout, including related payroll taxes and benefits as applicable, as the leave is earned. The annual leave and sick leave accrued liability was $14,175,947 and $13,690,150 at June 30, 2016 and 2015, respectively.

### 6.C. Deferred Compensation Plan

Industrial Insurance Fund employees have the option to participate in the state of Washington's Deferred Compensation Plan (DCP). There are no contributions made on behalf of employees to the DCP by the Industrial Insurance Fund. The DRS administers the DCP and contracts with a third party (currently Empower Retirement) for recordkeeping and other administrative services. The WSIB selects and monitors DCP's investment options based on advice and recommendations provided by the Employee Retirement Benefits Board.

## 6.D. Other Postemployment Benefits

Employees of the Industrial Insurance Fund are eligible to participate in the state of Washington's defined benefit Other Postemployment Benefit (OPEB) plan, a multiemployer plan, as administered by the state through the Washington State Health Care Authority (HCA).

### Plan Description and Funding Policy

Per RCW 41.05.065, the Public Employees Benefits Board (PEBB), created within the HCA, is authorized to design benefits and determine the terms and conditions of employee and retiree participation and coverage, including establishment of eligibility criteria for both active and retired employees. PEBB programs include medical, dental, life, and long-term disability insurance.

The relationship between the PEBB OPEB plan and its member employers and their employees and retirees is not formalized in a contract or plan document. Rather, the benefits are provided in accordance with a substantive plan. A substantive plan is one in which the plan terms are understood by the employers and plan members. This understanding is based on communications between the HCA, employers and plan members, and the historical pattern of practice with regard to the sharing of benefit costs.

The PEBB retiree OPEB plan is available to employees who elect to continue coverage and pay the administratively-established premiums at the time they retire, under the provisions of the retirement system to which they belong. Retirees' access to PEBB plans depends on the retirement eligibility of their respective retirement systems. PEBB members are covered in the following retirement systems: Public Employees' Retirement System, Public Safety Employees' Retirement System, Teachers' Retirement System, School Employees' Retirement System, Washington State Patrol Retirement System, and Higher Education.

Per RCW 41.05.022, retirees who are not yet eligible for Medicare benefits may continue participation in the state's non-Medicare community-rated health insurance risk pool on a self-pay basis. Retirees in the non-Medicare risk pool receive an implicit subsidy. The implicit subsidy exists, because retired members pay a premium based on a claims experience for active employees and other non-Medicare retirees. The subsidy is valued using the difference between the age-based claim costs and the premium. In calendar year 2015, the average weighted implicit subsidy was valued at $308 per member per month, and in calendar year 2016, the average weighted implicit subsidy is projected to be $304 per member per month.

Retirees who are enrolled in both Parts A and B of Medicare may participate in the state's Medicare community-rated health insurance risk pool. Medicare retirees receive an explicit subsidy in the form of reduced premiums. Annually, the HCA administrator recommends an amount for the next calendar year's explicit subsidy for inclusion in the Governor's budget. In calendar year 2015, the explicit subsidy was up to $150 per member per month, and it remained at up to $150 per member per month in calendar year 2016.

Administrative costs, as well as implicit and explicit subsidies, are funded by required contributions from participating employers. The subsidies provide monetary assistance for medical benefits. Contributions are set by the legislature each biennium as part of the budget process. The benefits are funded on a pay-as-you-go basis.

The plan has no investments or other assets. Accordingly, the PEBB OPEB plan is not reported in the financial statements of the state, nor is a separate financial report publicly available.

For information on the results of the most recent actuarial valuation for the OPEB, refer to: http://osa.leg.wa.gov/Actuarial_Services/OPEB/OPEB.htm

**Annual OPEB Cost and Net OPEB Obligation**

The state's (general government agencies and higher education institutions) annual OPEB cost (expense) is calculated based on the annual required contribution (ARC) of the state as the employer, an amount actuarially determined in accordance with the parameters of GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal costs each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed 30 years.

The annual OPEB cost recorded for the Industrial Insurance Fund represents an allocation of the total ARC of the state of Washington, adjusted for interest and amortization. The Industrial Insurance Fund's annual OPEB cost is calculated by the Washington State Office of the State Actuary (OSA) and is recorded by the OFM. The allocation is primarily based on L&I's number of active and retired employees in relation to the total number of active and retired employees of the state.

The following table shows components of the Industrial Insurance Fund's allocated annual OPEB costs and changes in the Industrial Insurance Fund's Net OPEB Obligation (NOO) for fiscal years 2016 and 2015. All contributions required by the funding method were paid.

**Components of Allocated Annual OPEB Cost**

| | Fiscal Year 2016 | Fiscal Year 2015 |
|---|---|---|
| Annual required contribution | $ 12,900,000 | $ 12,446,000 |
| Allocated interest on Net OPEB Obligation | 1,703,000 | 1,292,000 |
| Allocated amortization of Net OPEB Obligation | (1,574,000) | (1,180,000) |
| Allocated annual OPEB cost | 13,029,000 | 12,558,000 |
| Allocated contributions made | (2,525,000) | (2,284,000) |
| Increase in Net OPEB Obligation | 10,504,000 | 10,274,000 |
| Net OPEB Obligation, beginning of year | 42,573,000 | 32,299,000 |
| Net OPEB Obligation, end of year | $ 53,077,000 | $ 42,573,000 |

The Industrial Insurance Fund's NOO represents 1.9 percent and 1.8 percent of the state of Washington's NOO as of June 30, 2016 and 2015, respectively. The Industrial Insurance Fund's contribution was 1.5 percent of total employer contributions to the plan in each of the fiscal years ended June 30, 2016 and 2015, respectively.

The Industrial Insurance Fund's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the NOO for fiscal years 2016, 2015, and 2014 were as follows:

**Net OPEB Obligation**
by Fiscal Year

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| Allocated annual OPEB cost | $ 13,029,000 | $ 12,558,000 | $ 8,732,000 |
| Percentage of annual OPEB cost contributed | 19.4% | 18.2% | 25.1% |
| Net OPEB Obligation | $ 53,077,000 | $ 42,573,000 | $ 32,299,000 |

A complete description of the funded status and actuarial assumptions of the state of Washington's OPEB plan is included in the Comprehensive Annual Financial Report for the state of Washington. A copy of this report may be obtained by contacting the Accounting Division of the Office of Financial Management at P.O. Box 43127, Olympia, Washington 98504-3127, or online at http://www.ofm.wa.gov/cafr.

## Note 7 - Commitments and Contingencies

### 7.A. Commitments

Effective July 1, 1992, the Washington State Legislature required the Industrial Insurance Fund, under RCW 48.22.070, to participate in an assigned risk pool providing workers' compensation coverage under the United States Longshoreman and Harbor Workers' Act. The Industrial Insurance Fund is obligated to participate 50 percent in the underwriting losses or surpluses of the assigned risk pool. This participation is scheduled to continue indefinitely, due to amending legislation passed in 1997. In the history of this program, no assessments or distributions have been declared since enactment of this indefinite commitment.

### 7.B. Contingencies

The Industrial Insurance Fund is party to numerous routine legal proceedings that normally occur in operations. At any given point, there may be numerous lawsuits that could financially impact the Fund. Although the outcome of these lawsuits is not currently determinable, the resolution of these matters is not likely to have a material impact on the Industrial Insurance Fund's financial position, revenues, or expenses.

### 7.C. Current Litigation

The Industrial Insurance Fund has received a demand for certain funds under its retrospective rating program. The dispute is being proceeding through the statutory appeals process at the

Board of Industrial Insurance Appeals under Title 51 RCW. The Fund believe the claim is without merit and intends the vigorously defend its position. No amounts are reflected in the statutory financial statements as the cost of defense or result of the dispute is not probable or reasonably determinable at this time.

### 7.D. Exposure

The lack of diversity of exposure by line of business and by state could be a risk factor for benefit liability and claims administration expense (CAE) reserves. By statute, the Fund's direct exposure is limited to one line of business (workers' compensation) in one state (Washington). Therefore, any adverse trends affecting this line of business and/or state could have a material effect on the Fund's benefit liability and CAE reserves. Such trends would include legislative benefit level changes that may have an effect on all open workers' compensation claims.

## Note 8 - Leases

The Industrial Insurance Fund leases office facilities, office and computer equipment, and other assets under a variety of operating lease agreements. Although lease terms vary, most leases are subject to appropriation from the state legislature to continue the obligation. Since the possibility of not receiving funding from the legislature is remote, leases are considered non-cancelable for financial reporting purposes. Certain operating leases are renewable for specified periods. Management expects the leases to be renewed or replaced by other leases.

The total operating lease rental expenses for fiscal years 2016 and 2015 were $11,061,621 and $10,748,463, respectively. There are no contingent rental payments or unusual renewal options, escalation clauses or restrictions. During fiscal year 2016, the Industrial Insurance Fund reduced the number of laptops leased by 18 units which resulted in a decrease in lease payments of $941 per month. In addition, there was an increase of $1,788 in one month's lease payment due to the theft of two laptops.

Certain rental commitments have renewal options extending through the year 2021. Some of these renewals are subject to adjustments in future periods.

The following table presents future minimum payments for operating leases as of June 30, 2016:

| Future Minimum Payments June 30, 2016 | | | |
|---|---|---|---|
| **Operating Leases (by Fiscal Year)** | **Accident Account** | **Medical Aid Account** | **Total** |
| 2017 | $ 4,062,846 | $ 3,854,709 | $ 7,917,555 |
| 2018 | 2,450,969 | 2,273,103 | 4,724,072 |
| 2019 | 1,620,966 | 1,454,127 | 3,075,093 |
| 2020 | 1,022,522 | 1,022,522 | 2,045,044 |
| 2021 | 513,465 | 513,465 | 1,026,930 |
| **Total Future Minimum Lease Payments** | $ 9,670,768 | $ 9,117,926 | $ 18,788,694 |

## Note 9 - Sale, Transfer and Servicing of Financial Assets and Extinguishments of Liabilities

### Securities Lending

The Industrial Insurance Fund participates in securities lending programs with the WSIB and the OST to increase investment income. At June 30, 2016, the Industrial Insurance Fund had $114,580,717 of cash collateral received through the WSIB in the Accident and Pension Reserve Accounts. There was $253,777 of cash collateral received in the Medical Aid Account invested through the OST.

### Securities Lending – WSIB

Washington State law and WSIB policy permit the Industrial Insurance Fund to participate in securities lending programs to augment investment income. The WSIB has entered into an agreement with State Street Corporation to act as agent for the WSIB in securities lending transactions. As State Street Corporation is the custodian bank for the WSIB, it is counterparty to securities lending transactions.

Debt securities were loaned and collateralized by the Industrial Insurance Fund's agent with cash, U.S. government or U.S. agency securities, including U.S. agency mortgage-backed securities (exclusive of letters of credit). When the loaned securities had collateral denominated in the same currency, the collateral requirement was 102 percent of the fair value, including accrued interest of the securities loaned. All other securities were required to be collateralized at 105 percent of the fair value, including accrued interest of the loaned securities.

During fiscal years 2016 and 2015, securities lending transactions could be terminated on demand by either the Industrial Insurance Fund or the borrower. At June 30, 2016 and 2015, the cash collateral held had an average duration of 17.2 days and 22.5 days, and an average weighted final maturity of 73.4 days and 79.7 days, respectively. Because securities lending agreements were terminable at will, their duration did not generally match the duration of the investments made with the cash collateral. To provide liquidity to manage those mismatches, State Street Corporation is required to re-invest no less than the targeted 20 percent of the cash collateral received in the overnight maturities to ensure sufficient liquidity available for the return of collateral to borrowers within the ordinary course of business. In the event that loans are returned beyond what is expected in the ordinary course of business, State Street Corporation would be allowed to sell investments at its discretion and in accordance with the investment guidelines of the cash collateral account.

No more than 20 percent of the total on-loan value can be held by a specific borrower. Collateral investment guidelines specifically prohibit European-domiciled holdings. There are no restrictions on the amount of securities that can be lent. Securities were lent with the agreement that they would be returned in the future for exchange of the collateral. State Street Corporation indemnified the Industrial Insurance Fund by agreeing to purchase replacement securities or return the cash collateral in the event a borrower failed to return the loaned securities or pay distributions thereon. State Street Corporation's responsibilities included performing appropriate borrower and collateral investment credit analyses, demanding adequate types and levels of collateral, and complying with applicable federal regulations concerning securities lending.

During fiscal years 2016 and 2015, there were no significant violations of legal or contractual provisions, no failures by any borrowers to return loaned securities or to pay distributions thereon. Further, the Industrial Insurance Fund incurred no losses during fiscal years 2016 or 2015, resulting from a default by either the borrowers or the securities lending agents.

At June 30, 2016 and 2015, total collateral held was $114,896,901 and $106,455,879 and fair value of securities on loan were $112,010,405 and $102,621,078, respectively.

The market value of cash collateral assets at June 30, 2016 and 2015, was $114,580,717 and $68,151,292, respectively. The following tables provide information regarding cash collateral assets:

**Cash Collateral Held Under Securities Lending**
**June 30, 2016**
(in thousands)

| | | Book Adjusted | Level 2 | Maturity Date | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | NAIC Designation | Carrying Value | Fair Value | Under 30 days | 30 - 59 days | 60 - 89 days | 90 - 119 days | 120 - 179 days | 180 days - less than 1 year | 1 - 2 years |
| Cash and cash equivalents | 1 | $ 19,090 | $ 19,093 | $ 5,619 | $ - | $ 2,561 | $ 4,177 | $ 1,347 | $ 5,389 | $ - |
| Commercial paper | 1 | 19,363 | 19,365 | 6,870 | 1,077 | 269 | 1,314 | 2,021 | 7,814 | - |
| Repurchase Agreements | 2 | 13,202 | 13,202 | 13,202 | - | - | - | - | - | - |
| Repurchase Agreements | Not Rated | 32,331 | 32,331 | 32,331 | - | - | - | - | - | - |
| U.S. Treasuries | 1 | 1,078 | 1,078 | 1,078 | - | - | - | - | - | - |
| Yankee CDs | 1 | 25,461 | 25,468 | 5,120 | 4,716 | 3,369 | 3,504 | 3,369 | 4,042 | 1,348 |
| Corporate | 1 | 4,042 | 4,044 | 1,347 | - | - | - | - | 1,349 | 1,348 |
| **Total Cash Collateral Held** | | $ 114,567 | $ 114,581 | $ 65,567 | $ 5,793 | $ 6,199 | $ 8,995 | $ 6,737 | $ 18,594 | $ 2,696 |

**Cash Collateral Held Under Securities Lending**
**June 30, 2015**
(in thousands)

| | | | | Maturity Date | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | NAIC Designation | Book Adjusted Carrying Value | Level 2 Fair Value | Under 30 days | 30 - 59 days | 60 - 89 days | 90 - 119 days | 120 - 179 days | 180 days - less than 1 year | 1 - 2 years |
| Cash and cash equivalents | 1 | $ 12,220 | $ 12,220 | $ 3,298 | $ 666 | $ 1,332 | $ 2,663 | $ 1,331 | $ 2,930 | $ - |
| Commercial paper | 1 | 7,057 | 7,057 | 1,531 | 1,331 | 1,498 | 533 | 832 | 1,332 | - |
| Repurchase agreements | 2 | 1,665 | 1,665 | 1,665 | - | - | - | - | - | - |
| Repurchase agreements | Not Rated | 22,038 | 22,038 | 22,038 | - | - | - | - | - | - |
| U.S. Treasuries | 1 | 4,994 | 4,994 | 1,864 | 866 | - | - | 333 | 1,931 | - |
| Yankee CDs | 1 | 15,880 | 15,880 | 4,394 | 666 | 3,995 | 666 | 3,329 | 2,830 | - |
| Corporate | 1 | 4,295 | 4,297 | 666 | - | 466 | - | 1,166 | 666 | 1,333 |
| **Total Cash Collateral Held** | | $ 68,149 | $ 68,151 | $ 35,456 | $ 3,529 | $ 7,291 | $ 3,862 | $ 6,991 | $ 9,689 | $ 1,333 |

Non-cash collateral cannot be pledged or sold absent borrower default. Accordingly, non-cash collateral held under securities lending contracts with a value of $316,184 at June 30, 2016, and $38,304,587 at June 30, 2015, has not been included in the Consolidated Statutory Statement of Admitted Assets, Liabilities, and Contingency Reserve. Net earnings received through the securities lending program were $8,538 for fiscal year 2016 and ($182,063) for fiscal year 2015.

### Securities Lending – OST

State statutes permit the OST to lend its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The OST has contracted with Citibank, N.A. as a lending agent and receives a share of income from this activity. The lending agent lends securities and receives collateral, which can be in the form of cash or other securities. The collateral, which must be valued at 102 percent of the value of the loaned securities, is priced daily and, if necessary, action is taken to maintain the collateralization level at 102 percent.

Cash is invested by the lending agent in repurchase agreements, deposit accounts, or money market instruments, in accordance with investment guidelines approved by the OST. The securities held as collateral and the securities underlying the cash collateral are held by the custodian. One option available to the lending agent is to invest cash collateral into an OST account in the Local Government Investment Pool (LGIP). The LGIP portfolio is invested in a manner that meets the requirements set forth by the Governmental Accounting Standards Board for the external investment pools that wish to measure all of its investments at amortized costs. The funds are limited to high quality obligations with regulated maximum average maturities, the effect of which is to minimize both market and credit risk. The LGIP transacts with its participants at a stable net asset value per share of one dollar, which results in the amortized cost reported equaling the number of shares in the LGIP. During fiscal year 2016, cash received as collateral was invested in the LGIP money market fund and/or demand deposit accounts, which allow withdrawals each business day to cover maturing loans. At June 30, 2016 and 2015, the Industrial Insurance Fund’s cash collateral totaled $253,777 and $255,396, respectively, all of which was invested in the LGIP.

Contracts require the lending agent to indemnify the OST if the borrowers fail to return securities and if the collateral is inadequate to replace the securities lent, or if the borrower fails to pay the OST for income distribution by the securities' issuers while the securities are on loan. The OST cannot pledge or sell collateral securities received unless the borrower defaults. At June 30, 2016, the fair value of securities on loan for the Industrial Insurance Fund totaled $247,963. At June 30, 2015, the fair value of securities on loan was $249,293.

The OST investment policy requires that any securities on loan be made available by the lending agent for next day liquidity at the option of the OST. During fiscal years 2016 and 2015, the OST had no credit risk exposure to borrowers, because the amounts owed to the borrowers exceeded the amounts the borrowers owed to the OST.

There were no violations of legal or contractual provisions or any losses resulting from a default of a borrower or lending agent during the fiscal year.

## Note 10 - Changes in Benefit and Claims Administration Liabilities

The following schedule presents the changes in benefit and claims administration liabilities for the fiscal years ended June 30, 2016 and 2015, for the Industrial Insurance Fund:

**Changes in Benefit and Claims Administration Liabilities**
(in thousands)

| | Fiscal Year 2016 | Fiscal Year 2015 |
|---|---|---|
| **Unpaid benefit and claims administration liabilities, July 1** | $ 13,240,922 | $ 12,912,537 |
| Incurred benefit and claims administration liabilities | | |
| Provision for insured events of the current year | 1,780,902 | 1,818,597 |
| Increase in provision for insured events of prior years | 327,591 | 262,240 |
| Total incurred benefit and claims administration liabilities | 2,108,493 | 2,080,837 |
| Less Payments | | |
| Benefit and claims administration liabilities attributable to | | |
| Insured events of the current year | (303,784) | (300,862) |
| Insured events of prior years | (1,444,927) | (1,451,591) |
| Total payments | (1,748,711) | (1,752,453) |
| **Unpaid benefit and claims administration liabilities, June 30** | $ 13,600,704 | $ 13,240,921 |
| Current portion | $ 1,498,441 | $ 1,475,918 |
| Long-term portion | $ 12,102,263 | $ 11,765,004 |

It is expected that benefit and claim administration liabilities will change every year due to normal activities, such as adding the insured events of the current year, discounting existing liabilities, and paying claims. Benefit and claim administration liabilities also changed due to an increase of $327.6 million in the provision for insured events of prior years, mostly due to a $354.8 million change in the reserve discount and $27.2 million of net favorable development on prior years. The main reasons for the net favorable development is a reduction in the number of anticipated active time-loss claims based on recent data, offset by a reduction in the pension discount rate from 6.4 to 6.3 percent.

At June 30, 2016 and 2015, $21,539 million and $20,902 million of unpaid benefit and claims administration liabilities are shown at their net present and settlement value of $13,601 million and $13,241 million, respectively. In the Accident Account, liabilities for pensions incurred but not-yet-awarded are discounted on both a tabular and non-tabular basis. For each future pension award, the estimated future pension payments are discounted from the anticipated payment dates back to the anticipated date of the pension award on a tabular basis from 4.5 to 6.3 percent. The payments are then discounted from the anticipated date of the pension award back to the evaluation date, on a non-tabular basis, at 1.5 percent. For more information on discounting, see Note 1.C.3.

All other Accident and Medical Aid Account benefits and claims administration liabilities are discounted at 1.5 percent. The benefit liabilities in the Pension Reserve Account are discounted at 6.3 percent.

**Benefit Liability Development by Program**
**June 30, 2016**
(dollars in thousands)

| **Program/ Category** | **Undiscounted Liabilities** | **Discount Rate** | **Benefit Liabilities** |
|---|---|---|---|
| Accident | $ 7,289,006 | 1.5%, 4.5%-6.3% | $ 4,708,421 |
| Medical Aid | 5,272,937 | 1.5% | 3,927,450 |
| Pensions | 8,284,706 | 6.3% | 4,342,286 |
| Total Benefit Liability | 20,846,649 | | 12,978,157 |
| Claim Administration Expense (CAE) | 691,958 | 1.5% | 622,547 |
| **Total Benefit and CAE Liabilities** | $ 21,538,607 | | $ 13,600,704 |

**Benefit Liability Development by Program**
**June 30, 2015**
(dollars in thousands)

| **Program/ Category** | **Undiscounted Liabilities** | **Discount Rate** | **Benefit Liabilities** |
|---|---|---|---|
| Accident | $ 7,130,705 | 1.5%, 4.5%-6.4% | $ 4,688,010 |
| Medical Aid | 5,043,322 | 1.5% | 3,794,398 |
| Pensions | 8,085,993 | 6.4% | 4,177,750 |
| Total Benefit Liability | 20,260,020 | | 12,660,158 |
| Claim Administration Expense (CAE) | 641,493 | 1.5% | 580,764 |
| **Total Benefit and CAE Liabilities** | $ 20,901,513 | | $ 13,240,922 |

## Note 11 - Retrospectively-Rated Contracts and Contracts Subject to Redetermination

### 11.A. Method Used to Estimate

The Industrial Insurance Fund estimates accrued retrospective premium annual adjustments for unadjusted enrollment periods by reviewing historical participation and return patterns. The historical averages are used to arrive at an estimate of net retrospective return premiums for unadjusted periods. Cumulative return premiums for periods from the first annual adjustment through the third annual adjustment are system-generated, and the accruals are the difference between the cumulative returns and the amount already returned. The third annual retrospective adjustment is final.

### 11.B. Method Used to Record

Retrospective return premiums due to employers are netted with additional premiums due from employers and recorded as a liability.

### 11.C. Amount and Percent of Net Retrospective Premiums

Net premiums for the fiscal year ended June 30, 2016, on retrospectively-rated workers' compensation policies were $858.3 million, which were 40 percent of total workers' compensation net standard premiums earned. The net premiums for fiscal year ended June 30, 2015, on retrospectively-rated workers' compensation policies were $820.2 million, which were 41 percent of total workers' compensation net standard premiums earned for that year.

### 11.D. Calculation of Nonadmitted Retrospective Premiums

Retrospective additional premiums 90 days past due after the third annual retrospective adjustment are nonadmitted.

## Note 12 - Discounting of Liabilities for Unpaid Benefits or Unpaid Claims Administration Expenses

The case reserves shown in this exhibit are the reserves for pensions awarded through June 30, 2016, only. The Industrial Insurance Fund estimates case reserves on certain other individual claims solely for the purpose of classification rating, retrospective rating, and experience rating. Such case reserves are not maintained on claims that do not enter the rating calculations, so they are not meaningful for claims less than approximately 18 months old or more than approximately seven years old.

### 12.A. Tabular Discounts

The mortality tables are based on a 2014 study of Industrial Insurance Fund claimant data and the 2000 U.S. Census data. The liabilities for pensions already granted are discounted at 6.3 percent per annum. The liabilities for pensions incurred but not yet granted are discounted at rates from 4.5 to 6.3 percent, reflecting the pension discount rates anticipated to be in effect when the pensions are granted. The June 30, 2016, liabilities include $7,006,159,000 of such reserves, net of tabular discounts. The amount of the tabular discount for case reserves (i.e., pensions already granted) is $3,942,420,000 and is $2,194,230,000 for Incurred But Not Reported (IBNR) reserves at June 30, 2016.

At June 30, 2015, the liabilities, net of tabular discounts, amounted to $6,720,156,000. The amount of the tabular discount for case reserves was $3,908,243,000 and was $2,066,472,000 for IBNR reserves.

**Liabilities Discounted on a Tabular Basis***
**June 30, 2016**
(in thousands)

| Fiscal Accident Year | Undiscounted Benefit Liabilities Gross of Tabular Discount | Tabular Discounts | | Benefit Liabilities Net of Tabular Discount |
|---|---|---|---|---|
| | | Case | IBNR | |
| 2006 & Prior | $ 6,726,738 | $ 2,766,701 | $ 336,373 | $ 3,623,664 |
| 2007 | 749,394 | 255,786 | 122,608 | 371,000 |
| 2008 | 806,582 | 243,922 | 162,670 | 399,990 |
| 2009 | 729,671 | 201,760 | 164,962 | 362,949 |
| 2010 | 648,034 | 163,343 | 161,875 | 322,816 |
| 2011 | 615,429 | 120,309 | 182,292 | 312,828 |
| 2012 | 564,624 | 87,758 | 185,247 | 291,619 |
| 2013 | 560,334 | 52,016 | 212,109 | 296,209 |
| 2014 | 563,627 | 26,125 | 231,095 | 306,407 |
| 2015 | 583,523 | 14,737 | 224,236 | 344,550 |
| 2016 | 594,853 | 9,963 | 210,763 | 374,127 |
| **Total** | $ 13,142,809 | $ 3,942,420 | $ 2,194,230 | $ 7,006,159 |

*Includes liabilities for pensions already granted and pensions incurred but not yet granted.

### 12.B. Non-Tabular Discounts

The non-tabular discount rate is made up of a benchmark rate less a risk adjustment rate, rounded to the nearest one-half percentage point. The benchmark rate is the five-year moving average of the U.S. 20-Year Treasury yield. The risk adjustment equals two percentage points until the benchmark rate reaches 4.0 percent. Below 4.0 percent, the risk adjustment is one-half the benchmark rate rounded to the nearest one-half percent. As of June 30, 2016, the benchmark rate was 2.79 percent, and the indicated non-tabular discount rate was 1.5 percent. The non-tabular discount is calculated using the selected non-tabular discount rate and the anticipated payout of the liabilities.

The June 30, 2016, liabilities included $8,635,871,000 of reserves for benefits and $622,547,000 of reserves for claims administration expenses, net of tabular and non-tabular discounts. The amount of the non-tabular discounts for IBNR reserves was $1,731,842,000, the amount for defense and cost containment (DCC) expense reserves was $44,573,000, and the amount for adjusting and other (AO) expense reserves was $24,838,000.

The June 30, 2015, liabilities included $8,482,409,000 of reserves for benefits and $580,764,000 of reserves for claims administration expenses, net of tabular and non-tabular discounts. The amount of the non-tabular discounts for IBNR reserves was $1,625,147,000, the amount of non-tabular discount for DCC expense reserves was $38,765,000, and the non-tabular discount for AO expense reserves was $21,964,000.

**Liabilities Discounted on a Non-Tabular Basis***
**June 30, 2016**
(in thousands)

| Fiscal Accident Year | Benefit & CAE Liabilities Net of Tabular and Gross of Non-Tabular Discount | Non-Tabular Discounts: Case | IBNR | DCC | AO | Benefit & CAE Liabilities Net of Tabular and Non-Tabular Discount |
|---|---|---|---|---|---|---|
| 2006 & Prior | $ 2,783,510 | $ - | $ 559,189 | $ 13,818 | $ 3,279 | $ 2,207,224 |
| 2007 | 436,783 | | 75,505 | 1,812 | 926 | 358,540 |
| 2008 | 550,888 | | 91,284 | 2,200 | 1,261 | 456,143 |
| 2009 | 579,213 | | 95,703 | 2,295 | 1,338 | 479,877 |
| 2010 | 558,389 | | 89,272 | 2,159 | 1,360 | 465,598 |
| 2011 | 638,498 | | 98,065 | 2,385 | 1,644 | 536,404 |
| 2012 | 686,543 | | 102,175 | 2,534 | 1,818 | 580,016 |
| 2013 | 846,602 | | 122,320 | 3,110 | 2,291 | 718,881 |
| 2014 | 1,038,326 | | 143,410 | 3,763 | 2,863 | 888,290 |
| 2015 | 1,268,736 | | 162,457 | 4,528 | 3,598 | 1,098,153 |
| 2016 | 1,672,183 | | 192,462 | 5,969 | 4,460 | 1,469,292 |
| **Totals** | $ 11,059,671 | $ - | $1,731,842 | $ 44,573 | $ 24,838 | $ 9,258,418 |

*Excludes liabilities for pensions already granted, but includes liabilities for pensions incurred but not yet granted.

**Liabilities Discounted on a Non-Tabular Basis***
**June 30, 2015**
(in thousands)

| Fiscal Accident Year | Benefit & CAE Liabilities Net of Tabular and Gross of Non-Tabular Discount | Non-Tabular Discounts: Case | IBNR | DCC | AO | Benefit & CAE Liabilities Net of Tabular and Non-Tabular Discount |
|---|---|---|---|---|---|---|
| 2005 & Prior | $ 2,511,000 | $ - | $ 505,200 | $ 10,666 | $ 2,638 | $ 1,992,496 |
| 2006 | 373,865 | | 64,629 | 1,474 | 685 | 307,077 |
| 2007 | 488,746 | | 80,296 | 1,837 | 976 | 405,637 |
| 2008 | 624,616 | | 97,693 | 2,233 | 1,351 | 523,339 |
| 2009 | 660,474 | | 101,319 | 2,333 | 1,467 | 555,355 |
| 2010 | 658,672 | | 97,547 | 2,305 | 1,528 | 557,292 |
| 2011 | 687,857 | | 98,448 | 2,389 | 1,646 | 585,374 |
| 2012 | 745,598 | | 101,050 | 2,491 | 1,857 | 640,200 |
| 2013 | 1,002,845 | | 129,016 | 3,264 | 2,553 | 868,012 |
| 2014 | 1,285,994 | | 160,098 | 4,218 | 3,196 | 1,118,482 |
| 2015 | 1,709,382 | | 189,851 | 5,555 | 4,067 | 1,509,909 |
| **Totals** | $ 10,749,049 | $ - | $1,625,147 | $ 38,765 | $ 21,964 | $ 9,063,173 |

*Excludes liabilities for pensions already granted, but includes liabilities for pensions incurred but not yet granted.

## Note 13 - Related Party Transactions

L&I administers the state's Workers' Compensation Program, including the Industrial Insurance Fund. It is an agency of the state of Washington; therefore, other Washington State agencies are related parties. Certain goods and services, such as attorney general legal services, information technology services, facilities management, building security, and cash and investment management services, are provided to L&I by other state agencies.

Total expenses incurred for goods and services provided by other Washington State agencies were $52,313,406 in fiscal year 2016 and $49,196,899 in fiscal year 2015. During fiscal years 2016 and 2015, 87.6 percent and 88.6 percent, respectively, of the total related party expenses were to the Attorney General's Office, the Department of Enterprise Services, and Consolidated Technology Services. Total amounts due to other state agencies were $5,572,456 and $6,107,739 at June 30, 2016 and 2015, respectively.

The Washington State Legislature and the Governor provide appropriation authority from the Industrial Insurance Fund for use by the following Washington State agencies:

- **Board of Industrial Insurance Appeals** - hears appeals of decisions made by L&I
- **University of Washington** - promotes health and minimizes occupational disease or injury through teaching, research, and service
- **Department of Health** - completes surveys and on-site investigations of farm worker housing
- **Health Care Authority** - assists with reviews to develop preferred prescription drug lists
- **Joint Legislative Audit and Review Committee** - performs a performance audit of the workers' compensation claims management system

Total operating expenses incurred by these agencies in the Industrial Insurance Fund were $28,322,467 and $26,784,019 in fiscal years 2016 and 2015, respectively.

The Industrial Insurance Fund also transfers expenses and cash between the Accident, Medical Aid, and Pension Reserve Accounts, as well as the Supplemental Pension and Second Injury Accounts from the Workers' Compensation Program.

## Note 14 - Income Taxes

The Industrial Insurance Fund is exempt from federal income tax under the Internal Revenue Service Code sections 115 and 501(c) (26).

## Note 15 - Capital and Contingency Reserve

### 15.A. Capital

The Industrial Insurance Fund has no shares of stock authorized or outstanding.

### 15.B. Contingency Reserve

The contingency reserve represents net admitted assets available for financing ongoing operations and uncertainties not otherwise reserved. Changes in the contingency reserve are made up of investment and insurance operating results.

For fiscal years 2016 and 2015, changes in the contingency reserve resulted from the following:

**Explanation of Industrial Insurance Fund Operating and Investment Results**
(in thousands)

| | Fiscal Year 2016 | Fiscal Year 2015 |
|---|---|---|
| **Contingency Reserve, July 1** | $ 1,221,560 | $ 945,939 |
| **Unexpected Investment Results** | | |
| Actual unrealized and realized gains (losses) | | |
| Fixed income: unrealized gains (losses) | (76,587) | (5,132) |
| Equities: unrealized gains | (105,243) | 28,823 |
| Fixed income: realized gains | 63,491 | 40,573 |
| Equities: realized gains | 74,497 | 18,087 |
| Total actual unrealized and realized gains | (43,842) | 82,351 |
| Less expected gains | (70,200) | (76,230) |
| **Total Unexpected Investment Results** | (114,042) | 6,121 |
| **Unexpected Insurance Operation Results** | | |
| Development of prior years' loss and CAE liability | 27,254 | 273,441 |
| Development of prior years' retro refund liability | (5,148) | (26,310) |
| Premium adequacy | 389,774 | 48,600 |
| Nonadmitted asset results | (26,476) | (26,231) |
| **Total Unexpected Insurance Operation Results** | 385,404 | 269,500 |
| Change in contingency reserve | 271,362 | 275,621 |
| **Contingency Reserve, June 30** | $ 1,492,922 | $ 1,221,560 |

The contingency reserve balances by account for fiscal years 2016 and 2015 were:

| Contingency Reserve Balances by Account (in thousands) | | | | |
|---|---|---|---|---|
| | Accident Account | Medical Aid Account | Pension Reserve Account | Total |
| Contingency Reserve, June 30, 2016 | $ 489,517 | $ 1,003,405 | $ - | $ 1,492,922 |
| Contingency Reserve, June 30, 2015 | $ 279,916 | $ 941,644 | $ - | $ 1,221,560 |

## Note 16 - Asbestos and Environmental Reserves

Claims related to asbestos and hazardous chemicals or waste arise mainly as a result of the claimants' exposure at work and are covered by the Industrial Insurance Fund. There is not a large exposure, and it is not fundamentally different from any other injury due to exposure to hazardous materials in normal industrial activity. Case and IBNR reserves related to asbestos or environmental exposure claims are not specially reserved. IBNR and CAE reserves related to asbestos claims are included as part of benefit and CAE liabilities.

The table below shows a gross basis for the case reserves related to asbestos. L&I does not currently hold any reinsurance agreements.

| Workers' Compensation Asbestos Claims | | |
|---|---|---|
| | Fiscal Year 2016 | Fiscal Year 2015 |
| Beginning case reserve related to asbestos | $ 44,415,153 | $ 50,539,979 |
| Benefits incurred | 9,223,566 | 547,171 |
| Payments made | (7,939,339) | (6,671,997) |
| **Ending case reserve related to asbestos** | **$ 45,699,380** | **$ 44,415,153** |

Note: Amounts are case reserves and do not include IBNR or CAE reserves.

## Note 17 - Subsequent Events

For the annual Statutory Financial Information Report as of June 30, 2016, an analysis of subsequent events has been evaluated through the report issuance date of December 9, 2016. The events described below existed after June 30, 2016.

**17.A. Proposed Rate Announcement**

Each year, the Director of L&I adopts new workers' compensation insurance premium rates for the next calendar year. On September 21, 2016, the Director announced a proposed 0.7 percent increase in the average premium rate for 2017. The following four principles were used to guide the rate-setting process:

1. Set steady and predictable rate increases to help businesses plan ahead.
2. Benchmark rates against wage inflation (this happens automatically in other states).
3. Slowly rebuild the reserves to protect against unexpected changes.
4. Lower costs while focusing on better outcomes for injured workers.

The final rates will be adopted in early December 2016 and go into effect on January 1, 2017.

**17.B. Industrial Insurance Rainy Day Fund**

RCW 51.44.023 was enacted during the 2011, Legislative session, creating an Industrial Insurance Rainy Day Fund to hold transfers from the Accident and Medical Aid Accounts when assets for those accounts combined are between 10 and 30 percent of total liabilities for the Industrial Insurance Fund. Money from the Industrial Insurance Rainy Day Fund should be applied to reduce a rate increase or aid business in recovering from or during economic recessions. Per the June 30, 2016, Statutory Financial Information report for Industrial Insurance Fund, the combined assets of the Accident and the Medical Aid Accounts are in excess of 10 percent of total liabilities for the Industrial Insurance Fund. As a part of the 2017 rate-making process, the Director announced that he plans to restrict the Medical Aid Account contingency reserve (similar to restricted component of net position). The Medical Aid Account contingency reserve balance will be restricted by $107 million for the Industrial Insurance Rainy Day Fund.

# Supplementary Information

Washington State Department of
Labor & Industries

*Keep Washington Safe and Working*

# State of Washington Industrial Insurance Fund
## Schedule of Undiscounted Claims Development Information
### Fiscal Years 2007 through 2016
(dollars in millions)

The table below illustrates how the Industrial Insurance Fund's earned revenues (net of reinsurance) and investment revenue compare to the related costs of losses (net of loss assumed by reinsurers) and other expenses assumed by the program as of the end of each of the last ten fiscal years. The Industrial Insurance Fund has not purchased reinsurance since September 30, 2002, and has never had a qualifying event that generated a recovery.

The columns of the table show data for successive fiscal years.

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| Net earned required contribution and investment revenues | $ 2,406 | $ 1,697 | $ 1,692 | $ 2,797 | $ 2,525 | $ 2,581 | $ 1,928 | $ 2,888 | $ 2,113 | $ 2,931 |
| Estimated incurred claims and expenses, end of fiscal accident year | 2,196 | 2,256 | 2,363 | 2,312 | 2,254 | 2,086 | 2,105 | 2,061 | 2,304 | 2,205 |
| Paid (cumulative) as of: | | | | | | | | | | |
| End of fiscal accident year | 295 | 310 | 322 | 298 | 289 | 284 | 296 | 297 | 301 | 304 |
| One year later | 625 | 679 | 667 | 604 | 584 | 580 | 593 | 613 | 605 | |
| Two years later | 817 | 890 | 863 | 773 | 747 | 734 | 755 | 778 | | |
| Three years later | 953 | 1,042 | 1,000 | 890 | 857 | 840 | 866 | | | |
| Four years later | 1,059 | 1,162 | 1,107 | 981 | 940 | 918 | | | | |
| Five years later | 1,144 | 1,258 | 1,192 | 1,054 | 1,006 | | | | | |
| Six years later | 1,216 | 1,337 | 1,262 | 1,114 | | | | | | |
| Seven years later | 1,281 | 1,406 | 1,323 | | | | | | | |
| Eight years later | 1,340 | 1,466 | | | | | | | | |
| Nine years later | 1,391 | | | | | | | | | |
| Re-estimated incurred claims and expenses: * | | | | | | | | | | |
| End of fiscal accident year | 2,196 | 2,256 | 2,363 | 2,312 | 2,254 | 2,086 | 2,105 | 2,061 | 2,304 | 2,205 |
| One year later | 2,234 | 2,559 | 2,535 | 2,271 | 2,139 | 2,026 | 2,001 | 2,175 | 2,124 | |
| Two years later | 2,390 | 2,647 | 2,538 | 2,261 | 2,066 | 1,967 | 2,036 | 2,097 | | |
| Three years later | 2,441 | 2,724 | 2,485 | 2,137 | 2,012 | 1,878 | 2,025 | | | |
| Four years later | 2,526 | 2,662 | 2,411 | 2,147 | 1,986 | 1,960 | | | | |
| Five years later | 2,445 | 2,576 | 2,439 | 2,137 | 2,060 | | | | | |
| Six years later | 2,388 | 2,621 | 2,439 | 2,151 | | | | | | |
| Seven years later | 2,419 | 2,625 | 2,461 | | | | | | | |
| Eight years later | 2,421 | 2,660 | | | | | | | | |
| Nine years later | 2,455 | | | | | | | | | |
| Increase (decrease) in estimated incurred claims and expenses from end of policy year ** | 259 | 404 | 98 | (161) | (194) | (126) | (80) | 36 | (180) | |
| Percentage change in estimated incurred claims and expenses | 11.8% | 17.9% | 4.1% | (7.0%) | (8.6%) | (6.0%) | (3.8%) | 1.7% | (7.8%) | |

Source: Washington State Department of Labor & Industries Actuarial Services

* Re-estimated claims and expenses result from new information received on known claims, re-evaluation of existing information on known claims, and emergence of new claims not previously known.

** This line compares the latest re-estimated incurred claims amount to the amount originally established and shows whether this latest estimate of claims cost is greater or less than originally thought. As data for individual policy years mature, the correlation between original estimates and re-estimates is commonly used to evaluate the accuracy of incurred claims currently recognized in more recent fiscal accident years.

**Supplemental Investment Risk Interrogatories**
**June 30, 2016**

1. The Industrial Insurance Fund's total admitted assets as reported on page 31 of this annual Statutory Financial Information Report were $15,470,727,000 at June 30, 2016.

2. The following are the Industrial Insurance Fund's ten largest exposures to a single issuer/borrower/investment by investment category, excluding (i) U.S. government, U.S. government agency securities, and those U.S. government money market funds listed as exempt in the Appendix to the SVO's *Practices and Procedures Manual*, (ii) property occupied by the Industrial Insurance Fund, and (iii) policy loans:

| | Amount | Percentage of Total Admitted Assets |
|---|---|---|
| Bonds - Freddie Mac | $ 556,171,000 | 3.59% |
| Bonds - Fannie Mae | 394,808,000 | 2.55% |
| Bonds - Citibank Credit Card Issuance | 152,979,000 | 0.99% |
| Bonds - Novartis Capital Corp | 133,418,000 | 0.86% |
| Bonds - Bank of America Corp | 128,937,000 | 0.83% |
| Bonds - Citigroup Inc | 128,888,000 | 0.83% |
| Bonds - JPMorgan Chase & Co | 124,975,000 | 0.81% |
| Bonds - Burlingtn North Santa Fe | 110,861,000 | 0.72% |
| Bonds - Trans-Canada Pipelines | 106,669,000 | 0.69% |
| Bonds - Norfolk Southern Corp | 105,376,000 | 0.68% |

3. The Industrial Insurance Fund's total admitted assets held in bonds and preferred stocks, by NAIC designation, including bonds classified as short-term investments at June 30, 2016, were:

| | Amount | Percentage of Total Admitted Assets |
|---|---|---|
| Bonds with an NAIC rating of 1 | $ 9,198,919,000 | 59.46% |
| Bonds with an NAIC rating of 2 | 3,208,637,000 | 20.74% |
| Bonds with an NAIC rating of 3 | 282,970,000 | 1.83% |
| Bonds with an NAIC rating of 4 | 136,636,000 | 0.88% |

4. Assets held in foreign investments:

   Assets held in foreign investments exceeded 2.5% of the Industrial Insurance Fund's total admitted assets.

**Supplemental Investment Risk Interrogatories**
**June 30, 2016**

Total admitted assets held in foreign investments at June 30, 2016:

| Asset Type | | Amount | Percentage of Total Admitted Assets |
|---|---|---|---|
| Bonds | $ | 3,189,252,000 | 20.61% |
| Equities | | 695,000,000 | 4.49% |

Total admitted assets held in foreign investments in bonds by NAIC rating at June 30, 2016:

| NAIC Designation | | Amount | Percentage of Total Admitted Assets |
|---|---|---|---|
| Countries designated NAIC – 1 | $ | 1,905,293,000 | 12.32% |
| Countries designated NAIC – 2 | | 552,996,000 | 3.57% |
| Countries designated NAIC – 3 | | 730,962,000 | 4.72% |

The two countries with the largest foreign investment exposure in each NAIC designation at June 30, 2016:

| Issuer | NAIC Designation | | Amount | Percentage of Total Admitted Assets |
|---|---|---|---|---|
| Australia | 1 | $ | 419,676,000 | 2.71% |
| United Kingdom | 1 | | 391,270,000 | 2.53% |
| Indonesia | 2 | | 144,960,000 | 0.94% |
| Mexico | 2 | | 117,613,000 | 0.76% |
| SupraNational | 3 or below | | 285,578,000 | 1.85% |
| Brazil | 3 or below | | 220,349,000 | 1.42% |

**Supplemental Investment Risk Interrogatories**
**June 30, 2016**

Ten largest non-sovereign (i.e., non-governmental) investments held in foreign issues at June 30, 2016:

| Issuer | NAIC Designation | Amount | Percentage of Total Admitted Assets |
|---|---|---|---|
| Vale Overseas Limited | 2 | $ 93,660,000 | 0.61% |
| National Australia Bank | 1 | 89,886,000 | 0.58% |
| Westpac Banking Corp | 1 | 74,956,000 | 0.48% |
| Hutchison Wham Int 03/33 | 2 | 70,828,000 | 0.46% |
| Commonwealth Bk Austr NY | 1 | 64,961,000 | 0.42% |
| Alibaba Group Holding LTD | 1 | 64,764,000 | 0.42% |
| Siemens Financieringsmat | 1 | 59,945,000 | 0.39% |
| Itau Unibanco Hldg SA KY | 1 | 55,045,000 | 0.36% |
| State Grid Overseas Inv | 1 | 54,358,000 | 0.35% |
| Maccquarie Bank LTD | 1 | 53,976,000 | 0.35% |

| | Amount | Percentage of Total Admitted Assets |
|---|---|---|
| 5. Total admitted assets held in Canadian investments | $1,362,560,000 | 8.81% |

6. The Industrial Insurance Fund had no investments with *contractual sales restrictions*, which are defined as "investments having restrictions that prevent investments from being sold within 90 days."

7. The Industrial Insurance Fund's admitted assets held in equity interests, including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other equity securities (including Schedule BA equity interests) and excluding money market and bond mutual funds listed in the Appendix to the SVO's *Practices and Procedures Manual*, as exempt, or Class 1, were:

| Fund | Amount | Percentage of Total Admitted Assets |
|---|---|---|
| Blackrock MSCI U.S. IMI Index | $ 1,094,725,000 | 7.08% |
| MSCI EAFE Index SL CTF | 408,488,000 | 2.64% |
| MSCI Emerging Markets Free IND | 130,748,000 | 0.85% |
| MSCI Small Cap Index (Provisio) | 64,987,000 | 0.42% |
| Canada MSCI CTF | 39,676,000 | 0.26% |
| MSCI Equity Index Fund | 20,563,000 | 0.13% |
| MSCI Canada Small Cap | 7,179,000 | 0.05% |

Assets held in equity interest exceeded 2.5% of the Industrial Insurance Fund's total admitted assets.

**Supplemental Investment Risk Interrogatories**
**June 30, 2016**

8. The Industrial Insurance Fund did not hold any non-affiliated, privately-placed equities under Securities Exchange Commission (SEC) Rule 144a or SEC Rule 144 without volume restrictions.

9. The Industrial Insurance Fund did not hold general partnership interests.

10. The Industrial Insurance Fund did not own any mortgage loans.

11. The Industrial Insurance Fund did not have any individual parcels or groups of contiguous parcels of real estate.

12. The Industrial Insurance Fund held no investments in mezzanine real estate loans.

13. The Industrial Insurance Fund did not have admitted assets subject to repurchase agreements, reverse repurchase agreements, dollar repurchase agreements or dollar reverse repurchase agreements at June 30, 2016.

14. The Industrial Insurance Fund did not own any warrants not attached to other financial instruments, options, caps, or floors at June 30, 2016.

15. The Industrial Insurance Fund did not have any exposure for collars, swaps, or forwards during fiscal year 2016.

16. The Industrial Insurance Fund did not have any potential exposure for futures contracts during fiscal year 2016.

## Summary Investment Schedule
## June 30, 2016

The Industrial Insurance Fund held cash and invested assets as of June 30, 2016, consisting of the following:

| | Gross investment holding | | Admitted assets as reported in the annual statement | | | |
|---|---|---|---|---|---|---|
| | Amount | Percentage | Amount | Securities Lending Reinvested Collateral Amount | Total Amount | Percentage |
| Bonds: | | | | | | |
| U.S. Treasury securities | $ 2,008,377,000 | 13.54% | $ 2,008,377,000 | $ - | $ 2,008,377,000 | 13.54% |
| U.S. Government agency and corporate obligations | | | | | | |
| (excluding mortgage-backed securities) | - | 0.00% | - | | - | 0.00% |
| Foreign government (including Canada, | | | | | | |
| excluding mortgage-backed securities) | 1,185,411,000 | 7.99% | 1,185,411,000 | - | 1,185,411,000 | 7.99% |
| Mortgage-backed securities (includes residential and | | | | | | |
| commercial mortgage-backed securities) | | | | | | |
| Issued or guaranteed by GNMA | 45,414,000 | 0.31% | 45,414,000 | - | 45,414,000 | 0.31% |
| Issued or guaranteed by FNMA, FHLMC | 950,978,000 | 6.41% | 950,978,000 | - | 950,978,000 | 6.41% |
| Issued or guaranteed by all other | 183,554,000 | 1.24% | 183,554,000 | - | 183,554,000 | 1.24% |
| Other fixed income securities (excluding short-term): | | | | | | |
| Unaffiliated domestic securities | 4,915,286,000 | 33.14% | 4,915,286,000 | - | 4,915,286,000 | 33.14% |
| Unaffiliated foreign securities | 3,376,836,000 | 22.77% | 3,376,836,000 | - | 3,376,836,000 | 22.77% |
| Equity interests: | | | | | | |
| Commingled index funds - domestic | 1,094,724,000 | 7.38% | 1,094,724,000 | - | 1,094,724,000 | 7.38% |
| Commingled index funds - foreign | 671,640,000 | 4.53% | 671,640,000 | - | 671,640,000 | 4.53% |
| Real estate investments: | | | | | | |
| Property occupied by company | - | 0.00% | - | - | - | 0.00% |
| Property held for production of income | - | 0.00% | - | - | - | 0.00% |
| Receivables for securities and interest | 109,876,000 | 0.74% | 109,876,000 | - | 109,876,000 | 0.74% |
| Cash and cash equivalents | 12,526,000 | 0.08% | 12,526,000 | 77,813,000 | 90,339,000 | 0.61% |
| Securities lending collateral | 114,835,000 | 0.77% | - | - | - | 0.00% |
| Short-term investments | 161,305,000 | 1.08% | 161,305,000 | 37,022,000 | 198,327,000 | 1.33% |
| **Total** | $ 14,830,762,000 | 100.00% | $ 14,715,927,000 | $ 114,835,000 | $ 14,830,762,000 | 100.00% |

# Independent Actuarial Opinion

Deloitte.

Deloitte Consulting LLP
555 West 5th Street
Suite 2700
Los Angeles, California 90013
USA

Tel: + 1 213 688 0800
Fax: + 1 213 688 0100
www.deloitte.com

*September 30, 2016*

# Statement of Actuarial Opinion

## *State of Washington – Industrial Insurance Fund*

## Identification

I, Rod Morris, am a Specialist Leader with the firm of Deloitte Consulting LLP. I am a Member of the American Academy of Actuaries and meet its qualification standards for issuing Statements of Actuarial Opinion. I am a Fellow of the Casualty Actuarial Society. I was appointed by the Washington State Auditors' Office to provide a Statement of Actuarial Opinion regarding the reasonableness of the State of Washington Industrial Insurance Fund's ("the Fund") carried loss and loss adjustment expense reserves as of June 30, 2016.

The Fund is comprised of three Workers' Compensation Program Accounts: the Accident Account, the Medical Aid Account, and the Pension Reserve Account. The Fund is currently administered by the State of Washington Department of Labor & Industries ("the Department").

## Scope

I have examined the reserves listed in Exhibit A: Scope, as shown in the Fund's Statutory Financial Information Report, as of June 30, 2016. The loss and loss adjustment expense reserves ("reserves") specified in Exhibit A, where applicable, include provisions for Disclosure items (disclosures 8 thru 10) in Exhibit B. I have reviewed the June 30, 2016 loss and loss adjustment expense recorded under U.S. Statutory Accounting Principles. My review considered information provided to me through the date of this opinion.

In forming my opinion on the loss and loss adjustment expense reserves, I relied upon data provided by Mr. William Vasek, the Department's Chief Actuary, his actuarial staff, and Sharon Elias, the Department's Financial Services Program Manager. I evaluated that data for reasonableness and consistency. In other respects, my examination included the use of such actuarial assumptions and methods and such tests of the calculations as I considered necessary.

My review was limited to items listed in Exhibit A, and did not include an analysis of any other balance sheet items. I have not examined the Fund's assets and I have formed no opinion as to the validity or value of these assets.

## Opinion

In my opinion, the amounts carried in Exhibit A on account of the items identified:

(A) meet the requirements of the insurance laws of the State of Washington;

(B) are consistent with reserves computed in accordance with accepted actuarial standards and principles;

(C) make a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Fund under the terms of its contracts and agreements.

## Relevant Comments

### A. Risk of Material Adverse Deviation

With respect to this Statement of Actuarial Opinion, the amount of adverse deviation that I consider to be material is $298.6 million. My basis for determining this amount is 20% of the Contingency Reserve. This amount represents a reasonable upward fluctuation reserves from those carried by the Fund that would be material to the Contingency Reserve. My materiality standard was selected based on the context in which this opinion letter will be used. It is prepared solely to assess the reasonableness of the Fund's loss and loss adjustment expense reserves. Other measures of materiality might be used for reserves that are being evaluated in a different context.

I have identified the major risk factors for the Fund as the lack of diversity of exposure by line of business and by state, future medical trend, the discounting of the reserves, reserve leverage, and future cost of living adjustments. The potential impact of these risk factors is described in the following paragraphs. The absence of other risk factors from this listing does not imply that additional factors will not be identified in the future as having been a significant influence on the Fund's reserves.

By statute, the Fund's direct exposure is limited to one line of business (workers' compensation) in one state (Washington). Therefore, any adverse trends affecting this line of business and/or state could have a material effect on the Fund's loss and loss adjustment expense reserves. Such trends would include legislative benefit level changes and adverse decisions or interpretations of law that may have an effect on all open workers' compensation claims.

A major assumption in the analysis of the medical component of the workers' compensation reserves is the selection of a long-term medical trend factor to apply to future calendar year medical payments. Estimating medical trend has become increasingly difficult in recent years because it has been highly variable. In my opinion, there is a higher than normal degree of variability associated with the Fund's medical loss reserves due to the uncertainty surrounding future medical trends and the expected length of medical payments.

The Department discounts the loss and loss adjustment expense reserves to reflect the time value of money using an average annual interest rate of 3.51%. Changes to the interest rate used for discounting could result in material changes to the reserves. We note that the current risk free interest rate matching the duration of these liabilities was 2.10% as of June 30, 2016 and these rates have been trending lower for many years now. For example, the risk free interest rate matching the duration of these liabilities was 2.98% as of June 30, 2015.

The Fund defines its "Contingency Reserve" as the difference between its assets and liabilities. Other insurance companies typically refer to this Contingency Reserve as Statutory Surplus. Due to the size of the Fund's Contingency Reserve, $1.49 billion, relative to the size of its loss and loss adjustment expense reserve, $13.60 billion, any small changes in reserves will have a material impact on the Contingency Reserve. The current reserve leverage ratio (reserve / contingency reserve) is significantly higher than the majority of workers' compensation carriers in the industry and workers' compensation funds in other states, although the Fund's leverage ratio has been declining in recent years.

An implicit assumption in the Department's actuarial review is that the State of Washington cost of living adjustments will be similar to cost of living adjustments approved by the Federal Government for Social Security retirement benefits. Future State of Washington cost of living adjustments that vary significantly from those approved by the Federal Government for Social Security retirement benefits could result in a material change in future costs and the adequacy of the reserves, especially for the Pension Reserve Account.

The Fund is exposed to the uncertainty of variability of the reserves which could result in material adverse deviation. At this time, my assessment is that the Fund has a significant risk of a material adverse deviation.

## B. Other Disclosures in Exhibit B

### Underwriting Pools or Associations

The Fund participates in the Washington United States Longshore and Harbor Workers' Compensation Act Assigned Risk Plan ("WARP") which was established to provide USL&H workers' compensation insurance coverage for employers unable to purchase it through the normal private insurance market. The Fund pays assessments to WARP and participates in any underwriting losses or surpluses incurred by WARP. Based on discussions with the Department, we understand that WARP is not currently in a deficit position. Therefore, the Fund has not booked a reserve to account for any unpaid claim liability related to WARP.

We understand that the Fund does not participate in any other voluntary or involuntary pools.

### Asbestos Exposures and Environmental Exposures

I have reviewed the Fund's exposure to asbestos and environmental claims. In my opinion, the chance of material liability related to asbestos and environmental claims is remote. The Fund has not provided coverage that could reasonably be expected to produce material levels of asbestos and/or environmental liability claims activity.

### Disclosure of Unearned Premium Reserves for Long Duration Contracts

The Fund does not write single or fixed premium policies with coverage periods of thirteen months or greater which are non-cancelable and not subject to premium increase.

### Reinsurance

The Fund has no ceded or assumed reinsurance. Based on discussions with the Department's management and their description of the Fund's ceded (and/or assumed) reinsurance, I am not aware of any reinsurance contract that either has been or should have been accounted for as retroactive reinsurance or financial reinsurance.

### Discounting

The Department discounts the loss and loss adjustment expense reserves to reflect the time value of money. The amount of discount is based on an actuarially derived projected payment pattern and selected annual interest rates as follows.

- For the Medical Aid Account, the Department's selected interest rate is 1.5%.
- For the Pension Reserve Account, the Department's selected interest rate is 6.3%.
- For the Accident Account, combinations of interest rates are used to discount the reserves. The future total permanent disability and fatal transfers made to the Pension Account assume interest discounts based on an annual rate of 6.3% through the 1st quarter of 2017. This rate is reduced to 6.00% for the next 12 months and then is gradually reduced each additional 12-month period by 0.25% for the following six 12-month periods until settling on a long term annual rate of 4.5%. The actual transfer payments and all other payments are discounted using a Department selected rate of 1.5%.

The average combined interest rate for the Fund is approximately 3.51% with a total discount amount of $7.9 billion. The interest rates were selected by the Department, and I make no opinion regarding the appropriateness of the selected rates. We note that the current risk free interest rate matching the duration of these liabilities was 2.10% as of June 30, 2016 and these rates have been trending lower for many years now. For example, the risk free interest rate matching the duration of these liabilities was 2.98% as of June 30, 2015.

The interest rate used to discount the Pension Reserve Account changed from 6.4% last year to 6.3% this year. The effect of reducing these interest rate assumptions this year was an increase in the discounted unpaid claim liability of $34.4 million on the Pension Reserve Account reserve.

The interest rate used to discount the Accident Account future total permanent disability and fatal transfers made to the Pension Reserve Account continued to gradually decrease to 4.5% this year. Although, the rate at which the interest rates gradually decrease to 4.5% changed this year causing the discounted unpaid claim liability to decrease $10.6 million. The interest rate used for all other future payments remained the same this year at 1.5%.

The net effect of all the interest rate assumption changes combined this year was an increase in the discounted unpaid claim liability of $23.8 million including the current fiscal accident year.

**C. General Uncertainty**

In evaluating whether the reserves make a reasonable provision for unpaid losses and loss adjustment expense, it is necessary to project future loss and loss adjustment expense payments. It is certain that actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections. No warranty is expressed or implied that such variance will not occur. Further, my projections make no provision for the broadening of coverage by legislative action or judicial interpretation or for extraordinary future emergence of new classes of losses or types of losses not sufficiently represented in the Fund's historical data base or which are not yet quantifiable.

**Actuarial Report**

An actuarial report and underlying actuarial workpapers supporting the findings expressed in this Statement of Actuarial Opinion will be provided to the Department to be retained for a period of seven years in its administrative offices and available for regulatory examination.

This Statement of Opinion is solely for the use of assessing the reasonableness of the loss and loss adjustment expense reserves and is only to be relied upon by the Fund and the State.

Rod Morris

Rod Morris, FCAS, FSA, MAAA
Deloitte Consulting LLP
555 West 5th Street, Suite 2700
Los Angeles, CA 90013
(213) 688-3374
rmorris@deloitte.com
September 30, 2016

Statement of Actuarial Opinion – Year Ended June 30, 2016

*State of Washington Industrial Insurance Fund*

**Exhibit A: SCOPE**

| **Loss Reserves:** | **Amount** |
|---|---|
| 1. Net of Reinsurance Reserve for Unpaid Losses | $12,978,157,000 |
| 2. Net of Reinsurance Reserve for Unpaid Loss Adjustment Expenses | $ 622,547,000 |
| **Total Net Loss and Loss Adjustment Expense Reserves** | $13,600,704,000 |
| 3. Gross of Reinsurance for Unpaid Losses | $12,978,157,000 |
| 4. Gross of Reinsurance Reserve for Unpaid Loss Adjustment Expenses | $ 622,547,000 |
| **Total Gross Loss and Loss Adjustment Expense Reserves** | $13,600,704,000 |
| 5. Retroactive Reinsurance Reserve Assumed | $0 |
| 6. Other Loss Reserve items on which the Appointed Actuary is expressing an Opinion | $0 |
| **Premium Reserves:** | |
| 7. Reserve for Direct and Assumed Unearned Premiums for Long Duration Contracts | $0 |
| 8. Reserve for Net Unearned Premiums for Long Duration Contracts | $0 |
| 9. Other Premium Reserve items on which the Appointed Actuary is expressing an Opinion | $0 |

## Exhibit B: DISCLOSURES

| Item: | Column 1 | Column 2 | Column 3 | Column 4 |
|---|---|---|---|---|
| 1. **Name of Appointed Actuary** | | **Last**<br>Morris | **First**<br>Rodney | **Middle**<br>Scott |
| 2. **The Appointed Actuary's Relationship to the Company.** Enter E or C based upon the following:<br>E if an Employee, C if a Consultant | | | **C** | |
| 3. **The Appointed Actuary is a Qualified Actuary based upon what qualification?** Enter F, A, M, or O based upon the following:<br>**F** if a Fellow of the Casualty Actuarial Society (FCAS)<br>**A** if an Associate of the Casualty Actuarial Society (ACAS)<br>**M** if not a member of the Casualty Actuarial Society, but a Member of the American Academy of Actuaries approved by the Casualty Practice Council, as documented with the attached approval letter.<br>**O** for Other | | | **F** | |
| 4. **Type of Opinion, as identified in the OPINION** paragraph. Enter R, I, E, Q, or N based upon the following:<br>**R** if reasonable<br>**I** if Inadequate or Deficient Provision<br>**E** if Excessive or Redundant Provision<br>**Q** if Qualified. Use Q when part of the OPINION is Qualified.<br>**N** if No Opinion | | | **R** | |
| 5. **Materiality Standard expressed in $US** (Used to answer Question #6.) | $298,584,400 | | | |
| **6. Is there a Significant Risk of Material Adverse Deviation?**<br>YES or NO | | | | YES [ X ]<br>NO [ ] |
| 7. **Statutory Surplus (Contingency Reserve)** | $1,492,922,000 | | | |

**Exhibit B: DISCLOSURES**

| **Item:** | **Column 1** | **Column 2** | **Column 3** | **Column 4** |
|---|---|---|---|---|
| 8. Discount included as a reduction to loss reserves and loss expense reserves as reported in Schedule P | | | | |
| 8.1 Non-tabular Discount | $1,801,253,000 | | | |
| 8.2 Tabular Discount | $6,136,650,000 | | | |
| 9. The net reserves for losses and expenses for the Company's share of voluntary and involuntary underwriting pools' and associations' unpaid losses and expenses that are included in reserves shown on the Liabilities, Surplus and Other Funds page, Losses and Loss Adjustment Expenses lines. | n/a | | | |
| 9. The total claims made extended loss and expense reserve (Schedule P Interrogatories) | | | | |
| 9.1 Amount reported as loss reserves | n/a | | | |
| 9.2 Amount reported as unearned premium reserves | n/a | | | |
| 10. Other items on which the Appointed Actuary is providing Relevant Comments | n/a | | | |

***State of Washington Industrial Insurance Fund***
***Statutory Financial Information Report***

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