Secretary of State

State of Oregon

SAIF CORPORATION

Salem, Oregon

For the Years Ended December 31, 1998 and 1997

Audits Division

Contract Auditor: KPMG LLP

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Secretary of State

State of Oregon

SAIF CORPORATION

Salem, Oregon

For the Years Ended December 31, 1998 and 1997

Audits Division

No. 1999-34

October 18, 1999

OFFICE OF THE
SECRETARY OF STATE
Phil Keisling
Secretary of State
Suzanne Townsend
Deputy Secretary of State

AUDITS DIVISION
John Lattimer
Director

(503) 986-2255
FAX (503) 378-6767

Auditing for a Better Oregon

The Honorable John Kitzhaber, M.D.
Governor of Oregon
State Capitol
Salem, Oregon 97310

Katherine Keene, President and CEO
SAIF Corporation
400 High Street SE
Salem, Oregon 97312

This report on the audit of SAIF Corporation contains audited financial statements and a report on SAIF's compliance with laws, regulations, contracts and grants and on internal control over financial reporting. This audit was performed by KPMG LLP for the Audits Division, and covers the years ended December 31, 1998 and 1997.

OREGON AUDITS DIVISION

John N. Lattimer
Director

Fieldwork Completion Date:
July 30, 1999

255 Capitol Street NE • Suite 500 • Salem, Oregon 97310
INTERNET: Audits.hotline@state.or.us •http://www.sos.state.or.us/audits/audithp.htm

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KPMG

Suite 2000
1211 South West Fifth Avenue
Portland, OR 97204

Independent Auditors' Report

The Board of Directors and
Katherine Keene, President and Chief
Executive Officer, SAIF Corporation:

The Secretary of State Audits Division,
State of Oregon:

We have audited the accompanying balance sheets of SAIF Corporation as of December 31, 1998 and 1997 and the related statements of operations and changes in policyholders' equity and cash flows for the years then ended. These financial statements are the responsibility of SAIF Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SAIF Corporation as of December 31, 1998 and 1997 and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The year 2000 supplementary information on page 31 is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards Board, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because of the nature of the subject matter underlying the disclosure requirements and because sufficiently specific criteria regarding the matters to be disclosed have not been established. In addition, we do not provide assurance that SAIF Corporation is or will become year 2000 compliant, that SAIF Corporation's year 2000 remediation efforts will be successful in whole or in part, or that parties with which SAIF Corporation does business are or will become year 2000 compliant.

As discussed in note 2 of the notes to the financial statements, SAIF Corporation adopted Governmental Accounting Standards Board Statement No. 31, *Accounting and Financial Reporting for Certain Investment and External Investment Pools*, as of January 1, 1997.

In accordance with *Government Auditing Standards*, we have also issued our report dated July 30, 1999 on our consideration of SAIF Corporation's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations and contracts.

KPMG LLP

July 30, 1999

FINANCIAL STATEMENTS

SAIF CORPORATION

Balance Sheets

December 31, 1998 and 1997
(In thousands)

	1998	1997
Assets		
Investments (notes 2 and 3):		
Bonds	$ 1,812,103	$ 1,764,161
Equity securities	445,838	260,627
Other invested assets	31,818	12,693
Deferred compensation	–	19,506
Mortgage loans on real estate, at amortized unpaid balance	4,009	5,659
Total investments	2,293,768	2,062,646
Cash and cash equivalents (notes 2 and 3)	17,776	41,730
Securities lending cash collateral (note 3)	246,459	66,058
Accrued investment income	33,060	36,420
Premiums receivable, net of allowance for uncollectible accounts of $1,938 and $3,801 in 1998 and 1997, respectively (note 2)	80,991	81,001
Reinsurance recoverable on paid losses	77	104
Deposit with reinsurer (note 5)	71,741	143,520
Due from Workers' Compensation Division	12,927	13,339
Property and equipment, net of accumulated depreciation of $25,630 and $23,915 in 1998 and 1997, respectively (note 2)	32,317	32,679
Due from brokers for security sales	7,846	–
Other assets	6,489	6,873
Total assets	$ 2,803,451	$ 2,484,370
Liabilities and Policyholders' Equity		
Reserve for loss and loss adjustment expenses (notes 2 and 4)	$ 1,762,229	$ 1,723,264
Unearned premiums	36,368	20,147
Reserve for retrospective rating plans (note 2)	17,410	23,533
Reinsurance payable	2,974	2,556
Policyholders' premium deposits	4,036	6,334
Dividends payable to policyholders (notes 2 and 11)	130,425	80,000
Deferred compensation payable (note 9)	–	19,506
Securities lending collateral due borrowers	246,459	66,058
Premium taxes payable	15,446	13,246
Due to brokers for security purchases	5,000	–
Accounts payable and other liabilities	12,305	11,923
Total liabilities	2,232,652	1,966,567
Commitments and contingencies (notes 6 and 8)		
Policyholders' equity	570,799	517,803
Total liabilities and policyholders' equity	$ 2,803,451	$ 2,484,370

See accompanying notes to financial statements.

SAIF CORPORATION

Statements of Operations

For the Years Ended December 31, 1998 and 1997

(In thousands)

	1998	1997
Net premiums earned	$ 205,674	$ 225,155
Net investment income (notes 2 and 3)	286,690	247,989
Other income	–	1,399
Total revenues	492,364	474,543
Loss and loss adjustment expenses incurred (notes 2 and 4)	215,911	193,719
Policyholders' dividends (notes 2, 8, and 11)	171,544	79,835
Underwriting expenses	51,158	41,213
Other expenses	755	–
Total expenses	439,368	314,767
Net income	$ 52,996	$ 159,776

See accompanying notes to financial statements.

SAIF CORPORATION

Statements of Changes in Policyholders' Equity

For the Years Ended December 31, 1998 and 1997

(In thousands)

	1998	1997
Policyholders' equity, beginning of year	$ 517,803	$ 358,027
Net income	52,996	159,776
Policyholders' equity, end of year	$ 570,799	$ 517,803

See accompanying notes to financial statements.

SAIF CORPORATION

Statements of Cash Flows

For the Years Ended December 31, 1998 and 1997

(In Thousands)

	1998	1997
Cash flows from operating activities:		
Net income	$ 52,996	$ 159,776
Adjustments to reconcile net income to net cash provided by operating activities:		
Net change in fair value of investments	(150,124)	(106,303)
Depreciation expense	4,346	4,690
Change in:		
Accrued investment income	3,360	1,208
Premiums receivable, net	10	16,260
Reserve for loss and loss adjustment expenses	38,965	17,058
Unearned premiums	16,221	1,416
Reserve for retrospective rating plans	(6,123)	(292)
Policyholders' premium deposits	(2,298)	(1,678)
Reinsurance payable	418	298
Dividends payable to policyholders	50,425	10,000
Premium taxes payable	2,200	(14,106)
Deferred compensation payable	(19,506)	3,848
Due to policyholders from settlement against Oregon	–	(211)
Other assets	823	(204)
Accounts payable and other liabilities	382	(766)
Net cash provided by operating activities	(7,905)	90,994
Cash flows from investing activities:		
Purchases of investments-		
Bonds	(686,738)	(798,997)
Equity securities	(489,655)	(176,668)
Deferred compensation	–	(3,848)
Proceeds from sales and maturities of investments-		
Bonds	685,573	775,742
Equity securities	361,259	111,797
Other invested assets	24,373	29,350
Deferred compensation	19,506	–
Proceeds from repayment of mortgage loans-	1,838	1,689
Net cash used in investing activities	(83,844)	(60,935)
Cash flows from capital and related financing activities:		
Purchase of property and equipment	(3,984)	(6,652)
Return of deposit with reinsurer	71,779	(2,089)
Net cash provided by capital and related financing activities	67,795	(8,741)
Decrease in cash and cash equivalents	(23,954)	21,318
Cash and cash equivalents, beginning of year	41,730	20,412
Cash and cash equivalents, end of year	$ 17,776	$ 41,730

See accompanying notes to financial statements.

SAIF CORPORATION

Notes to Financial Statements

December 31, 1998 and 1997

(1) Description of Business and Regulatory Environment

SAIF Corporation (SAIF) is a public corporation created by an act of the Oregon Legislature. It traces its origins to 1914 when its predecessor organization commenced business.

SAIF is an insurance company authorized to write workers' compensation coverage in Oregon and certain other jurisdictions as required by the Department of Consumer and Business Services and to service accounts in the assigned risk pool. SAIF also provides incidental coverage governed by the Longshoremens' and Harbor Workers' Compensation Act, Jones Act, and Federal Employers Liability Law. SAIF's Board of Directors is appointed by the Governor of the State of Oregon (the State) and consists of prominent Oregon business and community leaders, not otherwise in the employ of SAIF.

SAIF writes business on a direct basis and through agents. During 1998 and 1997, 49% and 50% of gross premiums were written on a direct basis, respectively.

The Department of Consumer and Business Services enforces workers' compensation laws under Oregon Revised Statutes (ORS).

(2) Summary of Significant Accounting Policies

Basis of Accounting

At the request of the Oregon Secretary of State's Audits Division, SAIF has prepared the accompanying financial statements in accordance with generally accepted accounting principles. As a component unit of the State of Oregon, SAIF is subject to the pronouncements of the Governmental Accounting Standards Board. Under generally accepted accounting principles as applied to governmental entities, SAIF accounts for its activities as an enterprise fund. Accordingly, SAIF follows the accrual basis of accounting. Revenues are recognized when earned, regardless of when received, and expenses are recognized when incurred, regardless of when paid.

In accordance with Governmental Accounting Standards Board Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting", SAIF adopts only Statements of the Financial Accounting Standards Board issued prior to November 30, 1989.

Investments

In accordance with Governmental Accounting Standards Board Statement No. 31, “Accounting and Financial Reporting for Certain Investments and for External Investment Pools” (GASB 31), SAIF has stated investments at fair value as of December 31, 1998 and 1997. Changes in the fair value of investments are recorded as investment income (loss). Bonds, equity securities and other invested assets, which consist of investments in partnerships, are stated at fair value. Investments in partnerships consist of SAIF’s participating share in an investment fund, which generally consists of investment holdings in publicly traded companies, and is accounted for using the equity method. SAIF’s share of earnings or losses of the investment fund are reported as a component of net income. SAIF determines fair value for investment securities from prices quoted on national exchanges. Fair value for investment securities that are not traded on national exchanges is determined based upon quotes from licensed securities brokers. Fair value for investments in partnerships is determined based on the fair value of the underling investment holdings in the investment fund. Mortgage loans on real estate are stated at the amortized unpaid principal balance.

Realized investment gains and losses are determined using the specific identification method and are included as a component of net income upon the maturity or disposition of the investment. During 1998 and 1997, SAIF realized a net gain of $79.7 million and $55.4 million from sales of investments, respectively. The calculation of realized gains and losses is independent of the calculation of the net change in the fair value of investments. Realized gains and losses on investments held in more than one fiscal year and sold in the current year may have been recognized as a change in the fair value of investments reported in prior years. The net change in the fair value of investments during 1998 and 1997 was a $71.1 million gain and a $51.8 million gain, respectively. This takes into account all changes in fair value (including purchases and sales) that occurred during the year. The net unrealized gain on investments at December 31, 1998 and 1997 was $149.4 million and $96.1 million, respectively.

Cash and Cash Equivalents

SAIF places its temporary cash investments with the Oregon Short Term Fund. The Oregon Short Term Fund is a cash and investment pool that operates as a demand deposit account. By statute, the Oregon Short Term Fund may hold securities with maturities no greater than three years. The average maturity as of December 31, 1998 and 1997 was fifty-four and eighty-one days, respectively.

Concentrations of Credit Risk

Financial instruments which potentially subject SAIF to concentrations of credit risk consist principally of temporary cash investments and debt securities. SAIF places its investment securities with high-credit quality financial institutions and limits the amounts of credit exposure to any one financial institution. Concentrations of credit risk with respect to investments in debt securities are limited due to the large number of such investments and their distribution among U.S. government bonds, many different industries and geographic regions.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Maintenance, repairs and minor renovations are charged to expense as costs are incurred. Upon retirement or sale, any resulting gain or loss is included as a component of net income. Property and equipment is depreciated using the straight-line method over the estimated useful lives of the assets as follows:

Buildings and improvements	30 to 40 years
Furniture, equipment and machinery	3 to 7 years
Data processing software	3 to 5 years

At December 31, 1998 and 1997, property and equipment are comprised of the following (dollars in thousands):

	1998	1997
Land	$ 2,963	$ 2,963
Buildings and improvements	25,970	24,833
Furniture, equipment and machinery	20,546	21,523
Data processing software	8,468	7,275
Total	57,947	56,594
Less accumulated depreciation and amortization	(25,630)	(23,915)
Property and equipment, net	$ 32,317	$ 32,679

Depreciation and amortization expense for the years ended December 31, 1998 and 1997 was $4.3 million and $4.7 million, respectively. This charge includes both depreciation of purchased assets and amortization of assets accounted for as fixed assets under capital leases.

Premiums

Premiums are based on individual employers' reported payroll using predetermined insurance rates based on employee risk classifications and are recognized as income over the coverage period. Premiums are recognized as revenue on a pro rata basis over the policy term. Ceded premiums are recognized consistent with the underlying policy. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums.

Policyholders' premiums due to SAIF are recorded as premiums receivable, net of the allowance for uncollectible accounts. Premiums receivable consists of both billed and unbilled amounts. Unbilled premiums receivable, which are all earned, primarily represent an estimate of the difference between amounts earned ratably on installment-billed policies and the amount to be billed on the policy. Unbilled premiums receivable also include estimated billings on payroll reporting policies which were earned but not billed prior to year-end. SAIF uses its historical experience to estimate earned but unbilled amounts which are recorded as premiums receivable. These unbilled amounts are estimates, and while SAIF believes such amounts are reasonable, there can be no assurance the amounts ultimately received will equal the recorded unbilled amounts. The ultimate collectibility of the unbilled receivables can be affected by general changes in the economy and the regulatory environment due to the increased time required to determine the billable amount. SAIF considers these factors when estimating the receivable for unbilled premiums. Unbilled premiums receivable at December 31, 1998 and 1997 were $31.4 million and $40.1 million, respectively.

Certain policyholders are required to remit deposits which represent premium expected to be payable to SAIF at the end of the month following the reporting period (monthly and quarterly), plus one additional month. Deposits are generally in the form of cash. However, policyholders may pledge surety bonds and securities in lieu of cash deposits. At December 31, 1998 and 1997, there were no pledged bonds and securities.

In addition to its regular premium plans, SAIF offers employers retrospective premium rating plans under which premiums are adjusted annually for up to 4-1/2 years following the plan year based on policyholders' loss experience. Adjustments to the original premiums are paid to or collected from the policyholders six months following the expiration of the policy and annually thereafter for up to 4-1/2 years. The estimate of the net accrued premiums receivable for retrospective rating plans as of December 31, 1998 and 1997 is as follows (dollars in thousands):

	1998	1997
Accrued retrospective premiums receivable	$ 25,844	$ 30,766
Reserve for retrospective rating plans	(17,410)	(23,533)
Net accrued premiums receivable for retrospective rating plans	$ 8,434	$ 7,233

These amounts are included in the accompanying balance sheets.

Reserve for loss and loss adjustment expenses

The reserve for loss and loss adjustment expenses is generally based on past experience, except for certain awarded claims which are determined on an individual case basis. The liability includes provisions for reported claims, claims incurred but not reported, and claims that are currently closed but which experience indicates will be reopened.

Management believes that the reserve for incurred but unpaid loss and loss adjustment expenses at December 31, 1998 is a reasonable estimate of the ultimate net costs of settling claims and claims expenses incurred. Actual claim costs depend upon such factors as duration of worker disability, medical cost trends, occupational disease and inflation, and other societal and economic factors. As a result, the process used in computing the ultimate cost of settling claims and expense for administering claims is necessarily based on estimates. The amount ultimately paid may be more or less than such estimates. Adjustments resulting from changes in estimates of these liabilities are charged or credited to operations in the period in which they occur (see note 4).

Currently, SAIF discounts the reserve for unpaid fatal and permanent total disability losses. SAIF does not discount the reserve for unpaid fatal and permanent total disability loss adjustment expenses. Oregon Attorney General Opinion Number 6176 requires SAIF to use the discount rate that reflects the anticipated rate of return on investments taking into consideration the uncertainty inherent in long pay-out patterns. The discount rate used by SAIF is 3.5% at December 31, 1998 and 1997, respectively. Annually, the Board of Directors reviews the actuarial assumptions and discount rates utilized in determining the liability for such losses. The discount reflected in the reserve for loss and loss adjustment expenses was $94.8 million and $98.2 million at December 31, 1998 and 1997, respectively.

During 1998, SAIF changed the methodology for calculating the reserve for loss adjustment expenses. The method is based on estimated workloads for all outstanding claims along with future payroll and benefit inflation rates. This change in methodology increased the outstanding loss adjustment expense reserve by approximately $100 million during 1998.

Managed Care Organization Fees

SAIF contracts with managed care organizations (MCOs). MCOs manage claims by arranging to provide medical and health care services. The expense is based on the number of claims accepted and closed while managed by an MCO. Approximately 93% of SAIF's policies are covered by contracts with MCOs during 1998 and 1997.

Premium Deficiency

At December 31, 1998 and 1997, no reserve for premium deficiency was required to be recorded. Premium deficiency is based upon an estimate of the amount by which the sum of anticipated claims costs, claims adjustment expenses and maintenance expenses exceeds expected premium income and earnings on investments.

Policyholders' Dividends

Substantially all of SAIF's business is written under various participating plans wherein a dividend may be returned to the policyholder. Estimated amounts to be returned to policyholders are accrued when the related premium is earned. Dividends may be paid to the extent that a surplus is accumulated from premiums. Dividends paid to policyholders totaled $121.1 million and $69.8 million in 1998 and 1997, respectively.

Taxes and Assessments

SAIF as an agency of the State of Oregon is specifically exempted from federal income tax under Internal Revenue Code section 501(c)(27) as of January 1, 1998.

SAIF is subject to levies by the Oregon Workers' Compensation Division of the Department of Consumer and Business Services. Such assessments constitute an in-lieu-of-tax relative to premiums.

Use of Estimates

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

Reclassifications

Certain reclassifications have been made to the prior year balances to conform with current year presentation.

(3) Cash, Cash Equivalents and Investments

Cash and Cash Equivalents

At December 31, 1998 and 1997, cash and cash equivalents are as follows (dollars in thousands):

		1998		1997
Carrying Value:				
Oregon State Treasury	$	17,109	$	29,942
Custodian Bank		667		11,788
	$	17,776	$	41,730
Bank Balance:				
Oregon State Treasury	$	26,546	$	40,604
Custodian Bank		667		11,788
	$	27,213	$	52,392

The difference between the carrying amount and bank balance consists primarily of deposits in transit and outstanding checks.

Cash on deposit in state banks is covered by federal deposit insurance or is secured by the State Treasury at a minimum of 25 percent as required by statutes. Amounts held in the Oregon Short Term Fund are insured or secured by securities held by the State Treasurer or by its agent in the Treasurer's name. Deposits at the custodian bank are neither collateralized nor insured, but are backed by the full faith and credit of the custodian bank.

Investments

Oregon’s State Treasurer acts as SAIF's investment officer, investing in any instrument in which persons of prudence, discretion and intelligence would invest for their own accounts. The Oregon Investment Council establishes SAIF's investment policy.

Cash collateral received in exchange for securities lending is invested in the custodial agent’s short-term fund, which is considered an external investment pool for purposes of GASB 31. SAIF’s participation in this fund is voluntary. The fair value of investments held by this fund is based upon prices quoted on national exchanges. This fund is not registered with the Securities and Exchange Commission, but the custodial agent is subject to the oversight of the Federal Reserve Board and the Massachusetts Commissioner of Banks. The fair value of SAIF’s position in this fund is not the same as the value of the fund’s shares. No income from this fund was assigned to another fund by the custodial agent during the year.

Security transactions are recorded on a trade date basis, generally three business days prior to the settlement date. Due from brokers for security sales and due to brokers for security purchases was $7.8 million and $5.0 million at December 31, 1998.

SAIF's investments are classified in three categories of credit risk to give an indication of the level of risk assumed by SAIF. The three categories of credit risk are:

1. Insured or registered, or securities held by the State of Oregon or its agent in the State of Oregon's name for SAIF;

2. Uninsured and unregistered with securities held by the counterparty's trust department or agent in the State of Oregon's name for SAIF; and

3. Uninsured and unregistered with securities held by the counterparty, or by its trust department or agent but not in the State of Oregon's name for SAIF.

SAIF's investments by category at December 31, 1998 are as follows (dollars in thousands):

	Category				
	1	**2**	**3**	**Not Required to be Categorized**	**Carrying Amount**
Bonds:					
U.S. Government	$ 709,142	–	–	220,812	$ 929,954
International bonds	89,324	–	–	7,775	97,099
Corporate bonds	781,932	–	–	3,118	785,050
Total bonds	1,580,398	–	–	231,705	1,812,103
Equity securities:					
Russell 3000 Pooled Equity Fund	–	–	–	316,057	316,057
Other equity securities	124,767	–	–	5,014	129,781
Total equity securities	124,767	–	–	321,071	445,838
Other invested assets	–	–	–	31,818	31,818
Mortgage loans on real estate	–	–	–	4,009	4,009
Total	$ 1,705,165	–	–	588,603	$ 2,293,768

SAIF's investments by category at December 31, 1997 are as follows (dollars in thousands):

	Category 1	Category 2	Category 3	Not Required to be Categorized	Carrying Amount
Bonds:					
U.S. Government	$ 946,993	–	–	–	$ 946,993
International bonds	16,829	–	–	–	16,829
Corporate bonds	800,339	–	–	–	800,339
Total bonds	1,764,161	–	–	–	1,764,161
Equity securities:					
Barclay Global Investors' Equity Index Fund B	–	–	–	176,736	176,736
Other equity securities	83,891	–	–	–	83,891
Total equity securities	83,891	–	–	176,736	260,627
Other invested assets	–	–	–	12,693	12,693
Deferred compensation	–	–	–	19,506	19,506
Mortgage loans on real Estate	–	–	–	5,659	5,659
Total	$ 1,848,052	–	–	214,594	$ 2,062,646

The amortized cost and fair value of debt and equity securities at December 31, 1998 is as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 902,152	27,859	(57)	$ 929,954
Foreign bonds	94,984	3,770	(1,655)	97,099
Corporate bonds	727,545	62,058	(4,553)	785,050
Total bonds	1,724,681	93,687	(6,265)	1,812,103
Equity securities:				
Russell 3000 Pooled Equity Fund	264,229	52,734	(906)	316,057
Other equity securities	119,599	18,875	(8,693)	129,781
Total equity securities	383,828	71,609	(9,599)	445,838
Total	$ 2,108,509	165,296	(15,864)	$ 2,257,941

The amortized cost and fair value of debt and equity securities at December 31, 1997 is as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 936,597	12,144	(1,748)	$ 946,993
Foreign bonds	17,733	147	(1,051)	16,829
Corporate bonds	769,246	44,082	(12,989)	800,339
Total bonds	1,723,576	56,373	(15,788)	1,764,161
Equity securities:				
Barclay Global Investors' Equity Index Fund B	134,265	50,480	–	184,745
Other equity securities	70,812	6,559	(1,489)	75,882
Total equity securities	205,077	57,039	(1,489)	260,627
Total	$ 1,928,653	113,412	(17,277)	$ 2,024,788

The amortized cost and fair value of debt securities at December 31, 1998, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (dollars in thousands).

		Amortized Cost		**Fair Value**
Due in one year or less	$	159,855	$	160,924
Due after one year through five years		852,748		908,325
Due after five years through ten years		662,669		686,514
Due after ten years		49,409		56,340
Total	$	1,724,681	$	1,812,103

Net investment income is comprised of the following for the years ended December 31, 1998 and 1997 (dollars in thousands):

		1998		**1997**
Bonds	$	158,904	$	154,771
Equity securities		74,529		59,305
Mortgage loans on real estate		395		578
Interest on deposit with reinsurer		5,113		2,774
Other		49,231		32,008
		288,172		249,436
Less investment expenses		(1,482)		(1,447)
Total	$	286,690	$	247,989

Net realized gains and losses on sales of investments, which are included in net investment income, consist of the following for the years ended December 31, 1998 and 1997 (dollars in thousands):

		1998		1997
Gains:				
Bonds	$	28,370	$	26,866
Equity securities		56,300		10,986
Other invested assets		23,847		28,477
Total	$	108,517	$	66,329
Losses:				
Bonds	$	(17,862)	$	(9,616)
Equity securities		(10,945)		(575)
Other invested assets		–		(711)
Total	$	(28,807)	$	(10,902)
Net:				
Bonds	$	10,508	$	17,250
Equity securities		45,355		10,411
Other invested assets		23,847		27,766
Total	$	79,710	$	55,427

Proceeds from sales of investments in debt securities for the years ended December 31, 1998 and 1997 were $581.0 million and $612.5 million, respectively.

Securities lending agreements

SAIF participates in securities lending transactions in accordance with State of Oregon investment policies. The Oregon State Treasury has, through Securities Lending Authorization Agreements, authorized its custodians to loan its securities pursuant to a form of loan agreement. Both SAIF and the borrowers maintain the right to terminate all securities lending transactions on demand. There have been no significant violations of the provisions of securities lending agreements during 1998 and 1997.

The custodians lent fixed income and equity securities and received as collateral U.S. dollar-denominated cash, U.S. government and agency securities. Borrowers were required to deliver collateral for each loan equal to not less than 102% of the market value of the loaned security, or 105% in the case of international securities. The custodians did not have the ability to pledge or sell collateral securities absent a borrower default and SAIF did not impose any restrictions during the year on the amount of the loans the custodians made on its behalf. SAIF was fully indemnified against losses due to borrower default by the custodians. There were no losses during the year from the failure of borrowers to return loaned securities and no recoveries of amounts from prior losses.

The maturities of investments made with cash collateral generally do not match the maturities of their securities loans. Since the securities loans are callable on demand by either the lender or borrower, the life of such loans at December 31, 1998 is effectively one day. At December 31, 1998, SAIF had no credit risk exposure to borrowers. The market value of the collateral held and the securities on loan from SAIF as of December 31, 1998 and 1997, including accrued income, was $246.5 million and $66.1 million, respectively.

(4) Reserve for Loss and Loss Adjustment Expenses

SAIF has established a reserve for both reported and unreported insured events, which includes estimates of future payments of losses and related loss adjustment expenses.

The following table provides a reconciliation of the beginning and ending reserve for loss and loss adjustment expenses for the years ended December 31, 1998 and 1997 (dollars in thousands):

	1998	1997
Reserve for loss and loss adjustment expenses, beginning of year, discounted	$ 1,723,264	$ 1,706,206
Add: Discount of reserve for loss and loss adjustment expenses	98,214	107,720
Reserve for loss and loss adjustment expenses, beginning of year, undiscounted	1,821,478	1,813,926
Incurred losses:		
Provision for insured events of the current year	333,771	239,489
Provision for insured events of prior years	(117,860)	(45,770)
Total incurred losses	215,911	193,719
Loss payments attributable to:		
Insured events of the current year	(52,024)	(56,939)
Insured events of prior years	(128,304)	(129,228)
Total payments	(180,328)	(186,167)
Reserve for loss and loss adjustment expenses, end of year, undiscounted	1,857,061	1,821,478
Less: Discount of reserve for loss and loss adjustment expenses	94,832	98,214
Reserve for loss and loss adjustment expenses, end of year, discounted	$ 1,762,229	$ 1,723,264

The 1998 decrease in incurred losses related to insured events of prior years is primarily due to favorable development in claims experience related to permanent total disability claims, which was partially offset by the increase in the reserve for loss adjustment expenses due to a change in methodology (see note 2).

In estimating the reserve for loss and loss adjustment expenses, SAIF considers prior experience, industry information, currently recognized trends affecting data specific to SAIF and other factors relating to workers' compensation insurance underwritten by SAIF.

(5) Reinsurance

In the ordinary course of business, SAIF assumes and cedes premiums for purposes of risk diversification and limiting maximum loss exposure from catastrophic events through contractual agreements with reinsurers. If such assuming reinsurers are unable to meet the obligations assumed under these reinsurance agreements, SAIF would be liable to pay the obligation. To minimize its exposure to significant losses from reinsurer insolvencies, SAIF evaluates the financial condition of its reinsurers and monitors concentration of credit risk.

Throughout 1998 and 1997, SAIF maintained coverage for loss occurrences involving one person subject to a limit of $5.0 million in excess of a $5.0 million retention. Reinsurance for loss occurrences involving two or more persons is subject to a limit of $140.0 million in excess of a $10.0 million retention.

The following amounts have been deducted in the accompanying financial statements as a result of reinsurance ceded (dollars in thousands):

	1998	1997
Reserve for loss and loss adjustment expenses	$ 66,415	$ 79,130
Unearned premiums	798	1,094
Premiums written	1,746	2,635
Premiums earned	6,205	9,233
Loss and loss adjustment expenses incurred	5,965	10,016

In 1990, SAIF entered into a reinsurance contract with National Indemnity that is accounted for as a deposit. The deposit with reinsurer was $71.7 million and $143.5 million at December 31, 1998 and 1997, respectively. See also note 11.

SAIF is authorized to write business on behalf of the Oregon Workers' Compensation Insurance Plan (the Plan), administered by the National Council on Compensation Insurance through the National Workers' Compensation Reinsurance Pool. The Plan provides a guaranteed source of workers' compensation insurance for employers unable to obtain coverage because of unstable financial condition, poor loss experience, or the inherently dangerous nature of the work. SAIF cedes such business to the Plan. In addition, SAIF is also required to assume its share of premiums and losses from the Plan based on voluntary market share.

The following amounts are included in the accompanying financial statements as a result of participation in the Plan (dollars in thousands):

		1998		1997
Assumed:				
Reserve for loss and loss adjustment expenses	$	35,086	$	38,385
Unearned premiums		1,694		1,992
Premiums written		7,654		10,519
Premiums earned		7,952		10,832
Loss and loss adjustment expenses incurred		3,003		8,981
Ceded:				
Reserve for loss and loss adjustment expenses	$	46,608	$	55,298
Unearned premiums		798		1,094
Premiums written		5,385		8,064
Premiums earned		5,681		8,531
Loss and loss adjustment expenses incurred		3,892		1,595

(6) Lease Commitments

SAIF has entered into noncancelable lease agreements for computer equipment and related maintenance contracts that expire at various times through the year 1999. Ownership of the computer equipment will be transferred to SAIF at the end of the lease term. SAIF leases office space in several locations under operating leases expiring during various years through 2001. SAIF's future minimum lease payments under operating and capital leases at December 31, 1998 is as follows (dollars in thousands):

		Operating Leases		Capital Leases
1999	$	546	$	626
2000		400		–
2001		157		–
Total minimum lease payments	$	1,103		626
Less amount representing interest				21
Net future minimum lease payments			$	605

Lease expense was $747 thousand and $810 thousand for the years ended December 31, 1998 and 1997, respectively.

(7) Risk Management

The State of Oregon administers property and casualty insurance programs covering State government agencies through its Insurance Fund. The Insurance Fund services claims for: direct physical loss or damage to State property; tort liability claims brought against the State, its officers, employees, or agents; workers' compensation; and employees, elected officials, and members of commissions and boards for honesty and faithful performance. The Insurance Fund is backed by a commercial excess property policy with limits of $300 million and a blanket commercial excess bond with limits of $20 million.

As a state agency, SAIF participates in the Insurance Fund. The cost of servicing insurance claims and payments is covered by charging an assessment to each State entity based on its share of services provided in a prior period. The total statewide assessment of each coverage is based on independent biennial actuarial forecasts and administrative expenses, less carry-forward or equity in the Insurance Fund. Assessments for the years ended December 31, 1998 and 1997 were $125 thousand and $128 thousand, respectively.

(8) Contingencies

During the ordinary course of business, SAIF becomes involved in litigation arising out of matters incident to the conduct of its insurance operations. SAIF is represented in these actions by the Attorney General of the State of Oregon. In the opinion of management, based upon information furnished by counsel, the ultimate disposition of these actions will not have a material adverse effect on SAIF’s financial position.

On November 18, 1993, the Supreme Court of the State of Oregon handed down an opinion on *Alsea Veneer, Inc. v. State of Oregon*, which indicated that the expropriation of $81.0 million from the State Industrial Accident Fund in June 1983 by the State of Oregon was inappropriate. The Supreme Court ruled that the State of Oregon must repay the $81.0 million, with interest, to the State Industrial Accident Fund. The settlement agreement reached between the parties involved, which was approved by the Marion County District Court on February 26, 1996, required the State of Oregon to make three payments totaling $225.0 million of which $145.0 million is being distributed to SAIF policyholders. As of December 31, 1998, one additional payment from the State of Oregon of $80.0 million is payable during the next biennium. The Oregon Constitution requires a legislative appropriation of funds before funds may be paid by the State. Therefore, SAIF has not recorded a receivable related to the *Alsea Veneer, Inc. v. State of Oregon* settlement as of December 31, 1998. On July 12, 1999, the Governor of Oregon signed into law Senate Bill 5535 appropriating $80 million pursuant to the settlement agreement. The Oregon Department of Administrative Services transferred the $80 million to SAIF on July 13, 1999.

In November 1998, the Board of Directors declared a policyholder dividend of $80 million which is to be funded by an appropriation from the Oregon Legislative Assembly in 1999. According to section 6.3.3 of the 1995 Alsea Veneer, et al. v. State of Oregon, et al. Settlement Agreement among the State of Oregon, SAIF, and a class of SAIF insureds, the State must pay to SAIF $80 million within 30 days after adjournment of the regular session of the 1999 Legislature. According to this agreement, the payment to SAIF is to be used exclusively for statutory workers’ compensation purposes as determined by the management or the Board of Directors of SAIF. The Board of Directors decided that the $80 million, when received by SAIF, should be returned in the form of a dividend to policyholders. Accordingly, the $80 million dividend will be paid during 1999 soon after SAIF expects to receive the $80 million from the State. At December 31, 1998, such amount has been recorded as dividends payable to policyholders and is included in the accompanying balance sheet.

(9) Deferred Compensation Plan

A deferred compensation plan (plan) was authorized under Internal Revenue Code Section 457 and ORS 243.400 to 243.495. The plan is a benefit available to all SAIF employees wherein they may execute an individual agreement with SAIF to defer a portion of their current income until future years so as to shelter such funds from federal and state taxation until withdrawal. Participants cannot receive the funds until certain circumstances are met. Funds accumulated by SAIF under its plan have been invested with various financial institutions and insurance companies.

Plan assets are held in a custodial account or an annuity contract by the plan provider for the exclusive benefit of the participants or beneficiary. Participants' rights under the plan are equal to the fair market value of the deferred account for each participant. In 1998, the plan was amended to comply with Internal Revenue Code 457(g). Under the amended plan, the assets are no longer subject to SAIF’s general creditors. In accordance with Governmental Accounting Standards Board Statement No. 32, “Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans--a recission of GASB Statement No. 2 and an amendment of GASB Statement No. 31”, the plan assets and the corresponding liability are not reported in the accompanying balance sheet at December 31, 1998.

(10) Retirement Plan

SAIF's employees participate in the Oregon Public Employees' Retirement System (PERS); a cost-sharing multiple-employer defined benefit pension plan. PERS is administered by the Public Employees Retirement Board under the guidelines of ORS Chapter 238. The PERS retirement allowance, payable monthly for life, may be selected from twelve retirement benefit options. Options include survivorship benefits and lump sum refunds. The basic benefit formula is 1.67 percent of a member's final average salary multiplied by the member's number of years of service. Benefits may also be calculated under either a money match or an annuity-plus-pension computation if a greater benefit results. PERS also provides death and disability benefits. A copy of the Oregon Public Employees’ Retirement System annual financial report may be obtained from PERS, P.O. Box 23700, Tigard, Oregon 97281-3700.

All SAIF employees are eligible to participate in PERS after completing six months of service. Covered employees are required by state statutes to contribute 6.0 percent of their salary to the plan. Current law permits employers to pay employee contributions to the PERS. SAIF is required by statute to contribute actuarially computed amounts as determined by PERS. Rates are subject to change as a result of subsequent actuarial valuations. Currently the rate is 8.2 percent of each covered employee's salary. The amounts contributed by SAIF for the years ended December 31, 1998 and 1997 were \$5.2 million and \$5.6 million, respectively. SAIF employer contributions for the years ended December 31, 1998 and 1997 were \$3.0 million and \$3.4 million, respectively, which is equal to the required contributions for each year. Employee contributions paid by SAIF for the years ended December 31, 1998 and 1997 were \$2.2 million and \$2.3 million, respectively. In accordance with Governmental Accounting Standards Board Statement No. 27, no pension liability existed at December 31, 1998.

(11) Subsequent Events

The Board of Directors declared and paid a policyholder dividend of $50.0 million during the second quarter of 1999. These dividends are included in the accompanying financial statements as dividends payable to policyholders at December 31, 1998.

In accordance with contract provisions, SAIF received $29.5 million from National Indemnity on April 10, 1999.

SAIF CORPORATION

REQUIRED SUPPLEMENTARY INFORMATION

(UNAUDITED)

December 31, 1998

Year 2000 Readiness Disclosure

The following disclosure is required by the Governmental Accounting Standards Board and is provided under the provisions of the Year 2000 Information and Readiness Disclosure Act, Public Law 105-271.

SAIF is currently addressing year 2000 issues relating to its information technology systems and other electronic equipment. The year 2000 issue refers to the fact that many computer programs use only the last two digits to refer to a year. Therefore, both 1900 and 2000 would be referred to as "00." Business functions that rely upon electronic organization and communications of information may be adversely affected by such systems. Also, the year 2000 problem could affect electronic equipment – such as environmental systems, elevators, and vehicles – containing embedded computer chips that have date recognition features.

There are several stages involved in making information systems ready for the year 2000. These stages are:

- Awareness – Establishing a project plan and budget for dealing with the year 2000 issue.
- Assessment – Identifying the information systems and their components and checking them for readiness.
- Remediation – Making changes to systems to achieve year 2000 readiness. This can involve purchasing new equipment or rewriting computer code.
- Validation and testing – Determining that the conversion of existing systems was successful.

SAIF Corporation has completed the validation and testing stages for all its systems.

Because of the unprecedented nature of the year 2000 problem, its effects and the success of related correction efforts will not be fully determinable until the year 2000 and thereafter. Management cannot assure that SAIF Corporation is or will be year 2000 ready or that SAIF's remediation efforts will be completely successful.

SAIF Corporation's management does not expect the efforts to respond to potential Year 2000 problems to have a material effect on SAIF's financial position or results of operations. However, there can be no assurance that the systems or products of other companies on which SAIF's information systems rely will be timely converted or that any such failure to convert by the vendor, customer or another company would not have an adverse effect on SAIF's information systems or operations.

KPMG

Suite 2000
1211 South West Fifth Avenue
Portland, OR 97204

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

The Board of Directors and
Katherine Keene, President and Chief
Executive Officer, SAIF Corporation:

The Secretary of State Audits Division,
State of Oregon:

We have audited the financial statements of SAIF Corporation as of and for the year ended December 31, 1998, and have issued our report thereon dated July 30, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether SAIF Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting

In planning and performing our audit, we considered SAIF Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Governor of the State of Oregon, the Oregon Legislative Assembly, the Oregon Secretary of State, and the Board of Directors and management of SAIF Corporation and is not intended to be and should not be used by anyone other than those specified parties. However, this report is a matter of public record and its distribution is not limited.

KPMG LLP

July 30, 1999

FACTS ABOUT THE SECRETARY OF STATE AUDITS DIVISION

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DIRECTORY OF KEY OFFICIALS

Director	John N. Lattimer
Deputy Director	Sharron E. Walker, CPA, CFE
Deputy Director	Catherine E. Pollino, CGFM

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the best possible management of public resources.

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Oregon Audits Division
Public Service Building
Salem, Oregon 97310

503-986-2255

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Hotline: 800-336-8218
Internet: Audits.Hotline@state.or.us
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