The Plymouth Rock Company
INCORPORATED
695 Atlantic Avenue
Boston, Massachusetts 02111

Chairman's Letter

March 1, 1989

To Our Shareholders:

Nineteen eighty-eight marked the beginning of a transitional period for Plymouth Rock. Bolstered by the new shareholders and new capital we added at the close of 1987, we have committed to expand our horizons beyond Massachusetts personal lines. At one time, the founders of Plymouth Rock looked forward to the Company's becoming a profitable $50 million writer of Massachusetts automobile and homeowners insurance. We have passed that milestone now, and we have begun to think about larger scale and a broader product base. We do this in part because we believe our approach to the insurance business will work even better with greater size and in part because we remain nervous about vulnerabilities to the unique features of Massachusetts automobile insurance.

The management staff at Plymouth Rock has so far been geared to a single state and only two lines. If we expected to stay with this profile, we would already have a more than sufficient team to do the job. To expand, however, we must increase our management depth. Toward this end, we are initiating a program of recruiting talented executives, more of them in fact than our present operations require. Spending for the indefinite future does not come easily in a company that watches its expense budget so intensely. This is the first major program of investment since the Company's founding.

At the top, we are creating a position of senior vice president. This individual, an actuary perhaps, will work closely with Keith and me in molding and executing our growth plans. Aided by our product managers, our vice president for underwriting, and a new vice president for policy services, he or she will share in the Company's most important decisions. An excellent product manager has just joined us, with specific responsibility for exploring other jurisdictions in which we might write personal lines insurance. We have increased our strength in claims by the hiring of three highly experienced new managers, two at Plymouth Rock and the other at our affiliate, SRB Corporation. For the first time, we have the executive capacity for more claims than we currently handle.

Our processing systems are as much in need of upgrade as our top management staff if we contemplate a more complex future. In this area, we faced a major dilemma. We were not satisfied with the insurance software commonly available for purchase, but we were even less eager to accept the massive costs of building our own software from scratch. We are, therefore, negotiating a processing and development agreement with Policy Management Systems Corporation, the nation's largest insurance software concern. Plymouth Rock will help PMSC improve its Massachusetts services and develop new applications for its systems generally. PMSC will provide our basic processing services, allow Plymouth Rock the opportunity to try out experimental technologies, and will pay us a royalty on its improved or jointly-developed products.

Equally important, because PMSC has created products for all fifty states and numerous lines of business, PMSC will give us a more flexible environment for expansion than our present systems. Plymouth Rock will remain active in software development, but we hope that our efforts and talents can be devoted to the frontiers of data processing (such as agency automation and expert underwriting models) rather than the reinvention of basic record maintenance and policy issuance programs. We find this prospect exciting, although data processing is always a bit intimidating as well.

We finished 1988 a $60.6 million company, as measured by Gross Premiums Written. This is growth of 54% from the close of 1987. Net Premiums Earned, after all forms of reinsurance, were $15.9 million, up from $11.4 million last year. The ratio of automobile insurance premiums written to homeowners premiums written remains about six to one.

Not all of the 1988 volume increase in automobile insurance represents growth in the number of policies. That growth was aided by an eight percent announced rate increase, taking effect in January, and a subsequent retroactive rate increase of another eight percent in response to a remand of the Commissioner's rates by the Supreme Judicial Court of Massachusetts. This not only enlarged the volume numbers, but also set the stage for a possible correction of the long-running rate inadequacy in the Massachusetts auto insurance market.

The rate increases were followed up by a highly constructive piece of legislation. The law change increased the no-fault tort threshold, eliminated stacking of coverages within multiple-car households, redefined the nature of underinsured motorist protection, and improved the bargaining position of insurers with respect to auto repair shops. Had this law not been accompanied by a mandatory rate decrease of substantial proportions for 1989, the industry would have finally been back on solid footing in Massachusetts. Perhaps it was too much to hope for in a single year.

Rates are probably still inadequate, but the expected shortfall is smaller than it has been in any recent year. If he chooses to, the Commissioner can return us to adequacy in the next decision without a dramatic hike. The next problem to solve is the size of the residual market. Commonwealth Automobile Reinsurers, or CAR, operates as a reinsurance pool, currently accepting the premium and paying the claims for more than two thirds of all the private passenger vehicles in the state. Since the reinsured policies tend to have worse than average experience, CAR ends up pooling about 80% of the claim dollars. Its deficit is in the neighborhood of $500 million annually.

With a total automobile insurance market of $3 billion, two thirds reinsured, the entire voluntary premium base is about $1 billion. This means the average company will be assessed roughly 50 cents on every dollar of voluntary premium it accepts. The remaining half dollar, even adjusted for investment income, is nowhere near enough to cover the expected claims and expenses. So no company, except to capture CAR incentives in the form of assessment reductions, will write new business. Plymouth Rock and a few other companies seek out the incentives and grow, reducing the assessment percentage but constantly increasing our exposure to adverse changes in the system. Most companies respond to the 50 cent average load by shrinking their Massachusetts books and some have abandoned the state altogether. The system can not stabilize, even with adequate rates, until the CAR deficit diminishes as a percentage of voluntary premium.

If the deficit could be cut in half and if the size of the CAR pool could be halved simultaneously, the remaining $250 million deficit, spread over a $2 billion voluntary premium base, would represent an average assessment of 12.5 cents per voluntary premium dollar. This would be a healthy situation for the industry. If genuine cost-saving reform can hold rate increase needs to moderate inflationary gradations, the public will be less upset at insurers. This is what to hope for. Plymouth Rock must wish for the arrival of both depopulation and rate adequacy before the CAR incentive payments are too sharply diminished. The clock has already started, in the form of a four year phase-down of the incentives presently written into the rules. It will take especially strong will-power on the part of the state and the industry to depopulate CAR. I am more optimistic now than I have been in the past about whether it can happen, but to be so optimistic as to place all our eggs in this basket would be foolish.

We will grow in Massachusetts again next year. It is time, however, to look beyond as well. This is not to say that other jurisdictions are untroubled. California's Proposition 103 has dominated industry news since its passage in November, and well it should. It is a signal of deep consumer unrest, to which the industry must respond in an enlightened manner. It sometimes seems that insurance carriers regard the public as an adversarial force. It would be healthier to remember that the public is the assembly of customers we exist to serve.

Proposition 103 looks to me like a protest against insufficient regulation and against an impractical overdependence on territorial classification schemes. This is not to equate it with sweetness and light. The mandated rate rollback, absent cost-containing reform, seemed rather like illusory bait hooked to a regulatory strengthening that might otherwise have been defeated. Its message is loud nonetheless. The insurance industry needs to prepare for similar expressions of anger in other states where the precipitating conditions prevail. Companies obviously can't withdraw from every market in which consumers protest, though some may try.

An interesting subject of debate at Plymouth Rock is whether we should prefer to write next in other troubled states or in those without angry consumers and regulatory turmoil. The best argument for another hot seat is that growth is far more available where the competition is reticent. The best argument for calm is that it provides better balance to our current book. The answer has not yet emerged.

Plymouth Rock's Massachusetts loss experience for 1988 remained favorable. Our computer models for risk selection continue to sharpen, and we continue to apply the most rigorous standards to our selection of agents. As long as we can then follow up with the top quality service that makes agents and policyholders want to stay with us, we think this is a winning formula. Accordingly, the pure loss ratio, including IBNR and after excess reinsurance, remained far better than industry standards. Our loss adjustment expenses, however, were once again a couple of points above industry norms. The breakthrough in technique that will allow us to settle claims cheaply, accurately, and still to the full satisfaction of our customers, continues to elude us. Perhaps we will find it in the innovations encouraged by the new law. We certainly have the claims talent and the will. I am hopeful that next year's report can talk about how these ingredients translated into superior claims adjusting.

The expense ratio, measured on a gross budget basis to include loss adjustment and investment expenses, had reached 40% in 1987 on its long downward journey. I set a goal of 37% for 1988, and I must report that we failed to reach it. The expense ratio for 1988 was 38.4%, reflecting overages in policy processing services, our move to the Plymouth Rock Building at 695 Atlantic Avenue, and the additions to senior staff.

The moving costs are nonrecurring; and the current space actually costs less per square foot than our old space on Milk Street. We will feel, however, the bite of the salaries and policy processing even more next year. Since 1989 will be a year of rate reductions and higher commissions, both mandated by the regulators, these costs will have an even more adverse impact on the 1989 expense ratio. We will be lucky if we can keep the expense ratio from rising back over 39%. This is a setback, and I sincerely hope it is temporary. We need to get the gross expense ratio around 37% to be on a par with our Massachusetts competitors using independent agents, and we would have to get all the way down to 33% to compete someday on an even playing field with the national direct writers. As I have written before, to achieve a direct writer's expense ratio while providing excellent service in an agency environment may be the Company's hardest long term challenge.

The financial statements of insurance companies display expenses in a different manner. The ratio, from the income statement, of Other Underwriting Expenses to Premiums Earned is after the impact of reinsurance transactions and excludes loss adjustment and investment expenses. It shows a much healthier 24%. I wish this rosy number were as meaningful as the gross number we focus on, but it is not.

Investment policy continues to be conservative. We hold a portfolio of nearly $44 million now at Plymouth Rock. Forty-four percent of this is invested in debt securities of the federal government. Another 53% is invested in municipal bonds, and the remainder is in high grade corporate bonds and preferred stocks. The average maturity is quite short, under four years, and the portfolio duration is less than three years.

Our sister company, SRB Corporation, seems to have gotten off on the right foot in 1988. Its insurance company, Pilgrim, was licensed in March and immediately found clients for its insurance service offerings. Fireman's Fund, a preferred shareholder in SRB, hired us to collect some premiums left behind in its exit from Massachusetts. Amica Mutual Insurance and John Hancock Property and Casualty hired Pilgrim to process the commercial automobile policies they will be assigned by CAR. SRB is still small, but we think it has great potential. The selling of services to other insurers and self-insurers is a business virtually certain to expand over time.

As we look to 1989, we are especially proud of the staff that will help us face the challenges of expansion. When people come to work at Plymouth Rock, whatever their positions, they are told that half of job performance resides in how they treat other people. We want them to make our agents feel good about being associated with Plymouth Rock, to encourage their fellow employees to feel a sense of satisfaction through excellence in their work, and to remind our policyholders often how deeply appreciative we are for their having chosen us and stayed with us. We screen employment candidates for niceness as much as for their integrity, brains and commitment to hard work. This is the only way we know to build a company that can outperform its rivals in analytical acuity and customer service at the same time. Time will tell whether we succeed in the performance goals. So far, the indicators are positive. In the meanwhile, Plymouth Rock's staff has already made it a refreshingly pleasant place to work, a place of good cheer in a troubled industry.

James M. Stone

James M. Stone