

The Plymouth Rock Company

INCORPORATED

695 Atlantic Avenue

Boston, Massachusetts 02111

Chairman's Letter

March 1, 1990

To Our Shareholders:

This was a year of transitions. Two beloved Directors of Plymouth Rock Assurance Corporation died in 1989. Maurice Saval, who was close to ninety, died in February as the consequence of an automobile accident. He had lived a long life, but he was not yet ready to quit. Mr. Saval knew more about insurance than just about anyone. He successfully established an insurance brokerage practice over fifty years ago, and later created a successful family of insurance companies in the United States and Canada. When he sold the businesses and then retired in 1982, he devoted his legendary energies to the promotion and support of education. Plymouth Rock, in fact, was his only continuing business activity. He advised us wisely and often. If there are mercies in the nature of his death, they are these. He never had to be anyone's dependent, a role he would have hated. He was also spared witnessing the continued distress of his former flagship company. The company to which he gave so much of himself cannot at present serve as his monument. He will live on instead in the grateful memories of the many he helped to educate and advise.

Sandy Ellis died of a stroke just after Christmas. He was my first boss and inspiration in the business of insurance. Had I not known him, I doubt there would be a Plymouth Rock. I was a Harvard graduate student in 1972 when he and Leon Newman, the powers of the era at Fairfield & Ellis, hired me to serve as the Boston brokerage firm's economist. Sandy had a vision that insurance brokers would have to go beyond purchasing more and more insurance for their corporate clients. They must be prepared to recommend less insurance, self-insurance, or other alternative risk management vehicles, he insisted, even if the result was a reduction in traditional commission income. In this he was ahead of his time, and we were quite successful together at our mission for the firm.

I was paid fairly, but the real benefit of the job was time with Sandy. Never have I known anyone with more generosity of spirit, more ability to take pleasure from the successes of his many friends, and more just-plain decency. That he taught me the nuts and bolts of insurance is incidental compared to his lesson by example that both intellect and

moral force could be fully employed in this industry. I set out to learn the insurance business under Sandy Ellis's tutelage. A decade later, when I told him that Keith Rodney, Jim Bailey and I were founding a new insurance company, he was genuinely excited. He offered me interim office space in his executive suite and a small stipend to help get me through our initial year of planning. He honored us by serving as a Director of both the holding company and the insurance company, but he would never accept compensation. He died untimely, the holder of a great debt owed and uncollected.

This year was transitional in less personal respects as well. I have written repeatedly in past letters about the tenuous state of the auto insurance residual market rules, which have such a powerful impact on our performance. The residual market, Commonwealth Automobile Reinsurers or C.A.R., has since 1984 provided a monetary punishment for companies trying to exit the state and a concomitant reward for companies willing to grow. There has also been a sizeable reward for writing urban business. Since auto insurance rates were inadequate for most of this period, the economics of profitability depended on reaching for C.A.R.'s rewards. A shrinking insurer, especially if it deserted the cities, would be hit twice, by inadequate rates and by a C.A.R. penalty. A stable and balanced insurer would be neutral with respect to C.A.R. but squeezed by the rates. Only a growing company, with a healthy share of urban business, could prosper. We met this standard but constantly worried that the growth rewards would be removed before the rates became adequate.

Now the picture looks vastly different. In 1988, Governor Dukakis submitted to the state legislature a major law reform bill, which took effect in 1989. Unlike those states where there has been an assault on insurance premium levels coupled with no attempt at all to remove unnecessary costs from the system, Massachusetts tied a mandated rate reduction to meaningful reforms. Massachusetts may have a poor reputation in national insurance circles, but insurers who pay attention to the facts should use our Governor and our Legislature in this instance as models of responsible leadership. A rate reduction averaging over 7 percent was ordered for 1989, and it appears from preliminary observations that the savings from the new law will cover the entire reduction. Combining the law impact with the 8 percent overall increase announced for 1990, automobile insurance rates should now be adequate for the first time in a decade.

The law reform having been put in place, attention was quickly focused on the C.A.R. rules. Seeing no need to provide growth incentives in an environment of adequate rates, and assessing that there might be future systemic savings from depopulating the overstuffed residual market pool, Commissioner Gailey took it upon himself to redesign virtually all of the important C.A.R. rules. The principal thrust of his initiative was to phase out the growth incentive over a three year transition period and substitute a powerful incentive for companies to shift business out of the C.A.R. pool and into their voluntary books of business. Excessive pooling, here representing over two-thirds of the state's overall auto insurance volume, almost certainly takes the sharp edge out of insurance company cost containment efforts. When business moves back to the voluntary market,

the invisible hand will be ready to slap any carrier that becomes inattentive with respect to claims. That can only be good for the public.

Rule changes of this magnitude had not been forced by the Division of Insurance in over a decade, and a host of complex side effects of the new proposals threatened to slow down the process, but the Commissioner was adamant. It looked in October as though there would be a three-way feud among the Commissioner, the Legislative Joint Committee on Insurance, and various factions of the business. By December, a compromise had been forged that virtually everyone accepted. An overwhelming majority of the C.A.R. board, myself included, voted concurrence with the Commissioner's rules, and they took effect on January 1, 1990.

Though the impact on Plymouth Rock in the short run is attenuated by its transition provisions, the new plan has profound longer-term implications for us. Under the old rules, a company's bottom line was influenced as much by growth as by underwriting quality. Our underwriting was very good, so we were doubly blessed. Now there will be no reward for growth, but instead an incentive to keep business out of the pool. The urban credits have been retained and, in fact, increased. The company that does best in the future will be the one with the most flexible geographical mix, the most control over underwriting and, consequently, the least need for C.A.R.'s reinsurance. This system will prove stable only if independent agency companies can find strategies that produce low loss ratios without withdrawal of capacity from voluntary agents. We are thankful that Plymouth Rock begins, at least, with a strong book and a carefully selected geographical balance.

Plymouth Rock Assurance Corporation finished the year a \$69 million company measured by its gross writings. This is 14 percent growth from the close of 1988, the smallest increment in our six year history. The slow growth in premiums is largely due to the auto insurance rate decrease ordered for 1989. If our policy unit count had been coupled with a more typical 8 percent rate increase in 1989, the gross volume would have been up about 30 percent. We are in no way disappointed by the top line performance. Since the rate decrease appears to have been justified by the law reforms, there was no damage to our bottom line. And we are a company driven by quality and the bottom line. Net income for 1989 was \$3.84 million, up 28 percent from 1988.

The pure loss ratio declined since last year. The expense ratio rose. The first fact is good news, reflecting the continued success of our agency plant and our mathematical underwriting techniques. The second fact is bad news. We want to bring our expense ratio down over the years, and we must do so if we are ever to compete successfully with the direct writers in less regulated states. In 1988, we ran our business for 38.4 percent of gross premium, including every category of operational, investment and claims expense. This year, it cost us 40.3 percent of premium for everything other than a one-time insolvency fund assessment which is matched by a direct recoupment provision in the 1990 rates.

The two point expense ratio deterioration has several causes. The first is the impact of the rate decrease. Policy counts in 1989 continued to rise while the premium income per policy fell. Claims went down with the rates, but the costs of policy services, accounting and underwriting continued upward in their normal manner. The ratio of expenses to premiums was accordingly pushed higher. This is a one-time effect and not much cause for concern. The second reason for the expense increase was our conversion to Policy Management Systems Corporation software. We are as convinced as ever that PMSC is the best and the most economical alternative for us, but no one had pretended a conversion could be free. So far, the change is costing less than we budgeted and it is reasonably on schedule. This contribution to the 1989 expense ratio will not be repeated in future years.

The third cause of the expense ratio increase, however, can not be discounted as unique to 1989 and does represent a continuing concern. We simply have not figured out how to settle claims as efficiently as we must. Keith and I have both devoted considerable time in recent months to a series of experiments in this area. One involves the way we handle the incoming telephone load. Too many calls go to busy adjusters when others could handle them; too many calls require call-backs; too many calls are initiated by agents or policyholders when better communication on our part might have answered them in advance. Our methods for addressing this problem are still in the development stage.

The other thrust is a major overhaul of our field operations in claims. We have always been unhappy about the dominance of a three-party payment mechanism in the handling of automobile damage claims. The economy is replete with examples of how easily the costs of three-party mechanisms spin out of control. To our way of thinking, the body shop, the customer and the company form a dangerous triangle when all are involved in a simultaneous negotiation. So we now offer our policyholders, in keeping with a provision of the reform law, a choice of two-party mechanisms as optional alternatives to the traditional approach.

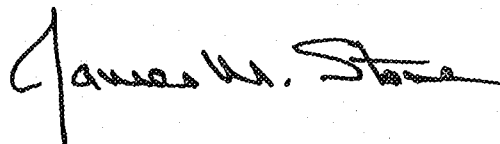
Our "Crashbusters" program promptly sends a Plymouth Rock van to the location of the damaged vehicle, allows our appraiser to perform a computer-aided evaluation of the loss, and usually results in a settlement with the customer which we promise will be honored by a list of recommended bodyshops. We can usually cut a check the same day. The customer is then free to conduct the final negotiations. If the cost is lower than our appraisal, the customer can keep the savings. Our "Door-to-Door" plan will provide a different two-party process, with even less work for the customer. If the policyholder wants us to, we will pick up the damaged vehicle and leave a rental car in its place. We will then negotiate with the body shop, effect the necessary repairs and return the vehicle. The repair is guaranteed by Plymouth Rock. Policyholders and agents seem to like these innovations. Their impact on cost remains to be discovered.

I am not yet confident we know how to do our business cheaply enough and still maintain our standards of excellence in service. We will continue to ponder and experiment until we find a way. I hope to report a resumption of our downward expense ratio trend this time next year.

Plymouth Rock's investments remain as conservative as ever. At \$44 million, the portfolio is too small to produce a meaningful return on the costs of top-flight research. We are growing so quickly, moreover, and earning enough on the underwriting side of the business that there would be a high cost to capital erosion from potential investment losses. As a consequence, we knowingly sacrifice some of the available return for the security of relatively passive management and safe holdings. Our current portfolio is entirely in top-grade, fixed income securities and has an average duration of less than three years. Eventually the economics must change, and the trade-offs will favor taking risk. In the near future, we may put a toe in that water but it will be some time before we want to swim with the high performance investors of our industry.

Last year's letter noted our search for a new senior executive and our interest in states other than Massachusetts. I am thrilled to report that Edward W. Ford, formerly the Chief Actuary of Progressive Casualty, will be joining us soon as Senior Vice President for marketing, underwriting and policy services. Ed brings with him an established reputation for brilliance and a humanistic philosophy. After the founders he will be our highest ranking officer. The exploration for opportunities in additional jurisdictions is in progress. It remains for some future report to announce the birth of our first infant company in a new state.

Whenever we operate in a next state, some aspects of our business may differ from the Massachusetts model. The most important features, however, we expect to hold constant. We are committed to hiring first-rate people, providing them an unusually happy and stable office environment, and expecting them to give us hard work, integrity and loyalty in return. The result is the sine qua non of our business: better service to the customer. We are committed to sophistication in automation, both operationally and in risk selection. We try to use cutting edge technologies and statistical methods a university professor would be proud of. We fight hard against any tendency to intellectual closed-mindedness or lack of respect for all we do not know. We are committed to good citizenship. We view the public as our primary constituency. The public, and its government officials, should never be made our adversaries. These principles have worked well for us in Massachusetts. I will be disappointed if their applicability proves other than universal.



James M. Stone