

Dryden review

DECEMBER 2004

This newsletter is intended to discuss issues of current interest to agents who represent Dryden Mutual. This is written as the rough equivalent of topics that would be covered in a current marketing visit from our professional staff. Please share this letter with all the people in your agency that work with us.

DID DRYDEN MUTUAL'S ATTEMPT AT A "SLOW-DOWN" WORK?

Dryden Mutual announced in May that our 2004 sales goal was revised to reduce our rate of growth from over +26% year-to-date at the end of April 2004 to below +15% by the end of 2004. Although we did not know if the market would assist us, and we did not know if this was feasible in such a short time, we did know that it was quite desirable strictly from a financial perspective. Contrary to common sense, statutory insurance accounting penalizes high levels of growth while rewarding low levels of growth, (see the results chart on the next page). After 3 straight years of high growth in a hard market, Dryden Mutual simply needed to retrench to protect our surplus position no matter how profitable the growth seemed to turn out.

After announcing an attempt to slow down growth in our May 2004 Newsletter, more than a few people (both inside and outside our company) wondered how such a slowdown might actually be accomplished without imposing new business moratoriums. But, instead of choosing moratoriums, we simply elected to become more conservative underwriters on our toughest classes of business without exactly knowing how this would statistically effect our growth in the 2004 changing marketplace. The final answer seems to have surprised everybody: our approach to slowing down not only worked exactly as it was intended; but we also have simultaneously obtained the desired positive benefits to our financial position (see the financial summary on the following page). The goal of getting the rate of growth down from +26% at the end of April 2004 down to well below +15% was completely accomplished ahead of schedule by the end of the third quarter!

WHY DID DRYDEN MUTUAL HAVE TO SLOW DOWN ITS RATE OF GROWTH?

The benefit of slowing down the rate of growth for an insurance company is to recapture profits forced into unearned premium reserves as technical losses to surplus. Contrary to general accounting rules, statutory accounting forces insurance companies to book virtually all net premium growth at a loss even if there were no claims involved. Insurance companies can silently tolerate this phenomenon with support from their internal profits on renewal business and investment income as long as growth remains below roughly +10% in any given year. However, as rates of return on investments started falling while at the same time premium growth jumped over +20% year after year in the hard markets of 2000-2004, growth for Dryden Mutual gradually became "acid" being thrown on policyholder surplus as it ate surplus away rather than build it up.

To replace the surplus drained away by excessive growth in the past several years, Dryden Mutual was successful in issuing a \$6,000,000 surplus note in May 2004 through a national pool interested in "arms length" (no control) long-term investments in smaller insurance companies. This added surplus situation has been reviewed by A.M. Best and they approve of such capital raising tools since almost all of the value of a surplus note directly flows into surplus. This phenomenon occurs because the company has the option to hold the surplus note for such a long period (up to 30 years). A.M. Best views these pooled surplus notes for mutual companies in much the same way as they view stock companies issuing new stock to raise capital additions to surplus.

A.M. BEST RELEASES SECOND 2004 RATING FOR DRYDEN MUTUAL

A.M. Best renewed Dryden Mutual's rating of "A- Financial Size Category V" on June 4, 2004 after reviewing year-end 2003 results and this is the rating published in the *Best's Key Rating Guide 2004* edition ("The Green Book"). However, A.M. Best also decided to review Dryden Mutual again to analyze the motivations and effects of issuing a surplus note in mid-2004. On October 8, 2004, A.M. Best formally notified Dryden Mutual that not only were they going to keep the "A-" rating in place for Dryden Mutual, but that our Financial Category Size (FSC) has been moved upward from *FSC V* to *FSC VI* because of the immediate positive impact of the surplus note. This is an important issue for many lending and certificate-accepting institutions. Lenders and other parties often not only demand a minimum letter rating from an insurer, but they also want a minimum FSC level. It is also reassuring that both the NYS Insurance Department and A.M. Best have had a chance to both scrutinize and approve this tactical maneuver to bolster Dryden Mutual's long-term policyholder surplus position.

SUMMARY OF KEY 2004 FINANCIAL STATISTICS FOR DRYDEN MUTUAL

Dryden Mutual has been able to continue a very favorable run of financial results in the past 8 years, and 2004 has been no different except perhaps even more profitable. The following financial numbers are identical to those submitted to the National Association of Insurance Commissioners (NAIC) and the New York State Insurance Department on our Annual Statements filed for the past 5 consecutive years through the third quarter in each year. The reported value of Dryden Mutual's surplus in the third quarter of 2004 includes a surplus note value of \$6,000,000. However, even if the value of our surplus note was subtracted, Dryden Mutual's surplus would still have grown over +34% through the third quarter due to the statutorily positive effects of slowing down the rate of growth by well over 10 points in the past 12 months. For those readers who still wonder why an insurance company would want to slow down its rate of growth even when producing a 77 combined ratio, please study the line below summarizing the magnitude of statutorily required additions to unearned premium reserves. By slowing down our rate of growth, the company has been able to cut the rate of loss to surplus by well over a million dollars in just a few short months!

	<u>09-30-00</u>	<u>09-30-01</u>	<u>09-30-02</u>	<u>09-30-03</u>	<u>09-30-04</u>
Direct Written Premium	\$12,184,610	\$14,536,960	\$18,401,768	\$23,169,637	\$26,528,729
YTD Growth Rate	+ 9.06%	+ 19.31%	+ 26.59%	+ 25.91%	+14.50%
Net Admitted Assets	\$ 28,983,192	\$ 32,848,664	\$ 38,696,541	\$46,305,046	\$ 61,539,005
Net Income Before Taxes	\$ 1,214,772	\$ 611,128	\$ 1,978,524	\$ 2,637,154	\$ 6,103,186
Addition to Unearned Premium Reserves	\$ 594,891	\$ 1,337,861	\$ 2,188,079	\$ 2,565,123	\$ 1,270,892
Policyholder Surplus	\$12,345,368	\$ 12,471,525	\$ 14,363,941	\$ 16,181,987	\$27,693,934
Combined (Trade) Ratio	97.88	99.87	88.00	88.08	77.54

DRYDEN MUTUAL IN THE NEW YORK STATE MARKET

A local research project done by Dryden Mutual management every year reveals many fascinating details of how things really turn out in just New York State as opposed to the national results reported in the trade press. This research is used to try to better understand what has happened to the 301 companies that actually wrote business in our state at any point during 2003 and how their specific lines of business performed in terms of both growth and loss ratios. Some find it hard to believe that even without writing automobile or workers compensation, Dryden Mutual was able to evolve into being the 101st largest overall property-casualty insurance company doing business in New York State at the end of 2003. Dryden Mutual's market rank is much, much higher on the lines of business that we do actually write. By the end of calendar year 2003, Dryden Mutual tended to rank among the top 50 or so companies on just those particular lines of business on which we actively participate in New York State:

28th for Commercial and Residential Fire combined
38th for Commercial Multi-Peril
43rd for Other Liability
47th for Homeowners Multi-Peril
51st for Inland Marine.

NYS ATTORNEY GENERAL PROBE INTO INSURANCE CONTINGENCY COMMISSION CONTRACTS

At this writing, the only information available about the direction of NYS Attorney General Elliott Spitzer's probe into commissioning arrangements in the insurance industry is coming from public sources such as the *Wall Street Journal*. In the November 29, 2004 daily edition of the *Wall Street Journal* on page C-1 of the "Money & Investing" Section, an article arose from concerns being expressed in California. The article managed to describe standard profit-sharing contingency contracts for all independent agents as "kickbacks" that need to be eliminated to protect the average public buyer of ordinary insurance products.

Until the NYS Insurance Commissioner advises Dryden Mutual otherwise, we still do not believe that our current profit-sharing contingency contracts meet the definition of "kickbacks" that disadvantage customers of independent agents. Virtually all of the independent agents we work with have always tried to act in the best interests of their customers while maintaining their contracted agent role for their respective carriers in an honorable and ethical manner. It is a very difficult role, but it always ultimately works to the benefit of the client public. Since virtually all carriers offer contingency commission arrangements as a matter of course, it is very difficult to see how any given contingency contract could really change the placement decisions and recommendations by our independent agents. If this were not the case, then very weak, shoddy insurance companies could easily and very quickly acquire market share by simply offering a couple more points of commissions while not providing much service to insureds. However, all the independent agents with whom Dryden Mutual is contracted uniformly demand excellent service at a reasonably competitive price or else they get rid of weak carriers, or at the very least refuse to give poorly performing or uncompetitively-priced companies little if any business from their respective offices.

After analysis in light of the Attorney General's probe, it is Dryden Mutual's opinion that our current contingency profit sharing arrangement with all of our contracted agencies is still justified and does no harm to the buying public's best interests when purchasing insurance products. There are four reasons for our position on this matter:

(a) Contingent commissions are already factored into the price of all products in the rate making process because such commissions have been consistently been paid to agents over many years. Suddenly banning all contingency commissions would greatly benefit insurance carriers like Dryden Mutual virtually overnight because companies could instantly recognize the savings simply as increased retained profits. Outlawing profit sharing contingencies would simultaneously hurt all independent agents by reducing their income potential, greatly benefit companies like Dryden Mutual (whom nobody wants to help), but would do virtually nothing to benefit the buying public since prices would remain the same for the insurance products they purchase.

(b) Our agents are not brokers and the flagrant abuses of public trust were committed only by brokers working on some of the largest accounts in the world. Brokers represent only the client during insurance transactions, whereas appointed agents are contracted to represent only the company in transactions. This is a fine distinction not understood by with the public and quite possibly not by the NYS Attorney General. The broker has the obligation to represent the interests of the client, with no regard to the best interests of any particular company. In contrast, the licensed agent has a contractual obligation to represent the company in specific transactions such as binding coverages and collecting premiums. Although the good agent will always try to balance the interests of the client and the company, the agent is only legally obligated to represent the company. The public already understands and accepts that agents are commissioned representatives of insurance companies, and revealing the exact level of contingent commissions to a customer is impossible since it is not known until after the close of any given calendar year and it is contingent on many factors not known at the time policies are sold individually.

©) The guaranteed excess commission “floor” rate in Dryden Mutual’s contingency contract is currently offered only to agents who produce over \$150,000 of direct written premium in any given calendar year. It is only offered strictly as a substitution for the conventional contingency “stop-loss” provision that acknowledges that claim severity is almost always a random event that could be caused not only by a single large loss, but also by local weather catastrophes that never produce any single large property claims. A stop-loss of \$100,000 per event almost never protected the commission income of any of our agents as we found out in the mid-1990’s. Any agent willing to commit a high minimum premium to Dryden Mutual in a given calendar year ought to have some protection against such accumulation of risk as is always inherent in our classes of business and that is what we provide with our “floor” commission.

(d) The growth incentives are made a part of many contingency contracts with independent agents, including Dryden Mutual’s current contract. However, growth itself is not rewarded, just profitability combined with growth on the entire book of business, not on the performance of any one client’s insurance policy. Both the growth and profitability incentives are deemed critical because contracted agents have binding authority from the company that could be either used judiciously or abused. In the final analysis, the Dryden Mutual contingency contract simply mirrors sales incentives offered in almost all other areas of marketing both tangible and intangible products in the United States wherein financial rewards are offered for higher sales volumes that turn out to be profitable.

HIGH EXPENSE & REINSURANCE COSTS FOR HOMEOWNERS

Although we generally report approximately a 40% overall company net expense ratio for Dryden Mutual on our annual financial statements, that does not mean that the same expense ratio really occurs on all lines of business. For example, our handling costs are very low on contractors packages, while our handling expenses are “sky-high” on homeowners. This is an even bigger problem when combined with the fact that contractors packages have very low actual annual paid claim costs, while homeowners packages produce the highest annual paid losses of any major line of product offered by Dryden Mutual. There is no easy resolution to this issue regarding homeowners, but the discussion of the problem is worthwhile to help our agents understand future management decisions regarding commission structure: the current debate is over continuing to offer 20% versus lowering the rate to 15% on a line of business that is nothing but a long-term major “loss leader.”

The subtle reason why we are agonizing over the hom eowners is that this line of business is not only a high loss ratio line of business, it is also our highest expense ratio line of business. All of our rate filings contemplate a 40% expense ratio while we know indirectly that the true expense ratio is closer to 70%. One study shows that to achieve just break-even results on homeowners, rates would have to be almost doubled from current levels, but this is not possible to file and get approved in New York State, nor could our agents sell this rate structure to their clients. Therefore, we are faced with either withdrawing homeowners and mobilehomes from our public insurance offerings or we have to let these lines continue to be heavily subsidized by more efficient lines of business in our office. As a fire insurance co-operative solely owned by our policyholders, Dryden Mutual has the impulse to find ways to keep offering such an important product because of the close tie-in to our other product lines.

To illustrate this point, the following study was done on calendar year 2003:

<u>Homeowners Claims, Billing and Policy Services Handling Expenses</u>			
Year Ending	HO/MHO Claims	Total Company Claims	Percent of Company Claims from HO/MHO
12-31-2003	781	2,408	32.43%
12-31-2003	Total Policies in Force	Total HO/MHO PIF	Percent of Company Handling from HO/MHO
	33,341	9,398	28.19%
12-31-2003	HO/MHO Inforce Premiums	Company Inforce Premiums	Percent of Revenue
	3,801,773	31,160,236	12.20%

Observation: The Homeowners line of business produces a highly disproportionate amount of claims, billing and policy handling expense in relation to the premium income generated. In recent years, over 30% of all unallocated claims handling expense and just under 30% of all non-claims handling expense was generated by a line of business that produced only 12% of the company's revenue. This phenomenon appears to be independent of any weather catastrophes and occurs in all years. Therefore, general overhead internal cost allocation to the HO/MHO line has to be approximately 2.5 times that of all other lines of business at Dryden Mutual.

High Homeowners Catastrophe Reinsurance Expenses

Catastrophe Reinsurance costs are generated almost entirely by the concentrations of homeowners risks, not commercial risks to quote our reinsurer, Swiss Re. At 12-31-03, our property catastrophe premiums were \$689,634 or 18% of our total \$3,812,476 HO/MHO Direct Written Premium as of 12-31-03. Most of Dryden Mutual's property catastrophe reinsurance costs are more properly allocated to the expense ratio for the homeowners line of insurance and therefore the hidden load of allocation of catastrophe reinsurance adds 18% to the general expense ratio.

So, how do we come to a 70% actual expense ratio on homeowners? Using very straightforward logic:

Reported 2003 Expense Ratio

38.8%	less	21.5%	base commission ratio against net (not direct) written premiums	
	less	4.9%	contingent commission ratio against net (not direct) written premiums	
	=	12.4%	general costs to run Dryden Mutual against net (not direct) premiums	
12.4% x 2.5	increase handling expense factor	=	31.0%	general handling expense factor for HO
			+ 21.5%	base commission ratio for HO/MHO
			+ 0.0%	contingent commissions because HO/MHO rarely help any agent generate a profitable overall loss ratio
			+18.0%	Catastrophe Reinsurance Cost to HO
			<u>70.5%</u>	True expense ratio of HO/MHO lines for Dryden Mutual

There is no way to carry over this logic to situations faced by other insurance companies which actively underwrite the homeowners line, whether large or small. No agent or competitor reading this newsletter should assume the exact numbers apply to their own organization or to other companies they represent. However, the odds are overwhelming that Dryden Mutual is not exactly alone in trying to deal with the cost dilemmas posed by this key line of business in New York State.

SNOWPLOWING COMPLETED OPERATIONS

Effective with new contracting business applications January 1, 2005, Dryden Mutual commercial lines underwriters will begin to add a clarifying endorsement (LS-79 Ed. 9/02) to all contracting new business where the agent does not ask for Dryden Mutual's snowplowing coverage. This endorsement excludes bodily injury and/or property damage due to completed operations relating to snow and ice control operations. It is not Dryden Mutual's intent to provide this coverage unless the insured elects to pay the additional premium for our Snowplowing Completed Operations charge that appears on our LS-5S schedule of general liability. The charge is flat for each overall policy limit of general liability and it is still only a very modest charge in today's market:

Policy Coverage	Snowplowing Flat Charge
CGL Limit \$ 100,000	\$ 67
CGL Limit \$ 300,000	\$ 89
CGL Limit \$ 500,000	\$105
CGL limit \$1,000,000	\$127

Dryden Mutual believes that some type of snowplowing operation is almost inevitable with contractors who own pick-up trucks in the Upstate New York climate which slows down regular contracting work during long winters, so this move is important to preserve our market position and get premiums for real exposures.

RESIDENTIAL COST ESTIMATORS FOR 2005

Effective January 1, 2005, Dryden Mutual underwriters will start using the attached new residential cost estimators to underwrite the replacement cost values placed on 1 to 4 family structures. Dryden Mutual has acquired rights to use the Saylor Publications residential cost estimator in conjunction with Underwriters Rating Bureau (URB). Although this new estimator is not perfect, it is also being used by many other Upstate New York property companies in Dryden Mutual's peer group, so it is the best available to us at this time. We will also continue to accept detailed, current cost estimators provided by other carriers since no one system has a monopoly on coming up with reasonably adequate insurable values.

This new residential cost estimator starts out with a base flat value for each of four basic types of houses, which is controversial but not totally unrealistic in actual practice. The attached instructions clarify the use of the Saylor System. One of the key features in using this system is that the flat starting point for each of the four base house classifications assumes a certain square footage for each of the four base types of structures. However, it is important to modify the value to fit the actual house upon which you are writing coverage. For example, a "standard" house class specifically contemplates 2,000 square feet, but if the specific "standard" house you are writing is 2,200 square feet then the starting value needs to be increased by +10%. Like the Marshall Swift/Boeckh estimators that were discontinued in 2003, the Saylor cost estimators also require additions for special individual structure features like decks, additional baths, added rooms, Jacuzzi's, and a host of other built-in items that are added after original construction and add tens of thousands of dollars to the actual insurable value of a given house. Shortcuts on calculating replacement or reconstruction values always lead to shortfalls in needed coverage after losses, so ask clients to be very detailed in their descriptions of the features of houses they want to insure and let them see your process so they can accept the outcome with ownership and not blame.

As we enter 2005, insurance-to-value remains in a crisis. Many out-of-state regulators and national consumer advocates are accusing the insurance industry of incompetence and collusion because the industry has failed to provide many people in Southern California and Florida with enough claim dollars to actually rebuild their houses after recent widespread natural disasters; and this shortfall arises even after every penny is paid out on policy limits! But, we also know that every single person reading this newsletter spends a part of all working days of an agency career debating proper insurance to value with customers. Many, if not most, clients seem to want to minimize coverage in order to save premium dollars, and therefore want to insure structures to only a perceived market value despite that fact that actual replacement or reconstruction values after a total loss are almost inevitably much, much higher. Selling full replacement cost or even higher reconstruction cost policies is universally viewed by the public as price gouging of consumers. But after a major loss or a widespread catastrophe, it is always a very different story and the industry gets the full blame. All we can do as insurance professionals is doggedly keep pointing out how inexpensive it always is to insure to higher, more appropriate limits.

E-MAIL TO DRYDEN MUTUAL

Dryden Mutual has instituted two new general e-mail addresses designed for accepted all varieties of claims and underwriting communications:

claims@drydenmutual.com
underwriting@drydenmutual.com

We request that this new e-mail address be used rather than those of individual Dryden Mutual staff because important inquiries need to be addressed expeditiously. In the past we have found important e-mail requests with short time lines directed to a specific individual on our claims or underwriting staff who was actually out on vacation or illness, and no one else could access the personal electronic mailboxes of the staff who were away.

Please use this new general address for the following types of communications:

- Newly reported claim notices
- New Policy Applications for All Lines of Business
- New Requests for Quotes on All Lines of Business
- Endorsement Requests on All Types of Policies
- Certificates of Insurance
- General Underwriting Correspondence on All Lines

This address is intended to help those agencies that have the capability of sending direct e-mails from their agency management systems. New items sent to this general underwriting e-mail address are now automatically routed into our Imaging System and then distributed to the appropriate departments several times daily. E-mailing new requests directly to an individual claims representative or a specific underwriter can slow response time if that person is away from the office. However, if a specific person on our staff has already corresponded with your office via an e-mail regarding a certain claim or policy, we still encourage your direct reply to that person at their individual e-mail address.

DRYDEN MUTUAL STAFF DIRECTORY

Many agents try to keep current company contact information up to date for agency staff, so going into 2005, please find attached a complete list of individual contact information at Dryden Mutual. An e-mail directory is enclosed with a reminder of the issue discussed above, so use e-mail to individuals only for information directed only to those individuals. The enclosed telephone directory is especially important because it lists internal extension numbers which are useful if trying to contact an individual either before or after official office hours (when the "office is closed" recording comes on, you can still dial right through the recording to an individual extension – many of our staff work before and after official closing)

STAFF TRANSFERS AT DRYDEN MUTUAL

Dryden Mutual has transferred some of our staff into other positions as we grow. Since the middle of this year, the following staff changes have occurred:

June 2004 – **Bertha Nicholas – Policy Services Representative**

Early retiree and former Human Resources Manager at Cornell University for 25 years
Hired full-time in the first stages of our conversion to digital imaging as a Scanner
Transferred to Policy Services in June 2004

June 2004 – **Mary Ellen Spoonhower – Policy Services Representative**

Licensed Practical Nurse since 1993
Hired Full-Time at Dryden Mutual as our First Scanner in August 2003
Transferred to Policy Services Department in June 2004

October 2004 – **Stephanie M. Ridley – Transferred to Policy Services**

Student Intern from Groton High School at Dryden Mutual January to June 2003

2003 Summer Intern while finishing BOCES studies in Cosmetology
Hired Full-Time at Dryden Mutual as another Scanner in November 2003
Transferred to Policy Services Department in October 2004

NEW STAFF AT DRYDEN MUTUAL

On June 21, 2004, we hired **Christopher L. Keech** as an Imaging Scanner. He had previously worked with us on a part-time basis from July 23, 2002 through June 21, 2004 as a student intern while he was in his last two years at Dryden High School. Chris was in our insurance InVEST/EIP class at Dryden High for two years, so we learned to respect his work both at school and on the job. He is working full-time for Dryden Mutual but is working on his associates degree at Tompkins Cortland Community College part-time.

Peter J. Vercillo was hired on July 12, 2004 as a Senior Claims Representative for Dryden Mutual. He came to us with over 10 years of progressively more responsible claims experience at the State Farm Group in Syracuse. He is a 1988 graduate of Canisius College in Buffalo and he has earned 3 insurance professional designations: Associate in Claims (AIC), Associate in Management (AIM) and Chartered Property Casualty Underwriter (CPCU). In addition, he earned a Masters in Business Administration (MBA) from Walden University in 2003. Since Dryden Mutual's highest business concentration is in the Onondaga County, Peter will continue to reside with his family in Syracuse, but work out of our office in Dryden.

Effective October 4, 2004, **Stephanie M. Tracy** was hired as another Imaging Scanner as an addition to staff. She had worked at Dryden Mutual part-time since November 2, 2002 as another of our student interns from Dryden High School. Stephanie graduated from Dryden High School in 2004 and is now attending Tompkins Cortland Community College to pursue an associates degree on a part-time basis with tuition assistance from Dryden Mutual in the same arrangement we offer to many other of our employees.

PLANS FOR 2005

At this time of year most agents want to know what their companies are expecting to do in terms of premium sales goals expectations in the coming year. Dryden Mutual's published plan is to try to anticipate growth in 2005 around +10%. However, the big question as 2004 closes is whether this +10% is still a "ceiling" on top of excessive growth potential still remaining in 2005, or whether +10% is a "stretch" goal in a softening 2005 market. After 3 straight years of 20% compounded annual growth in 2001-2002-2003, we needed to slow down in 2004 and digest the business that we have written as new in the past years of a hard market, but we still need to grow in 2005 on a modest scale. The trade press and some of our larger agencies are telling us that competition is returning in commercial lines both on standard small and conventional large accounts and this may have assisted in the 2004 slow-down efforts. But, in late 2004 we are still seeing only limited competition returning to Dryden Mutual's specialty niches, and non-renewals are still emerging on entire classes of business from among our largest competitors.

SEASONS GREETINGS

The Directors and Employees of Dryden Mutual wish the best to all our agents and their staff in this holiday season. We continue to be grateful for the continued support you provide to our franchise in Upstate New York. Thank you for your part in making 2004 one of the best years in the history of Dryden Mutual. We all look forward to the continued partnership in 2005. Although we are saddened to have to repeat this message every year at this time, also please join in us in again wishing a safe return home for all our brave men and women serving in the armed services across the world during these troubled times. At the end of 2004, this wish applies especially to the Army's 10th Mountain Division based near Watertown whose soldiers are continuing to face repeated deployments to combat zones.

Robert B. Baxter, CPCU, CIC
CEO & General Manager