



James V. Rosati
President & CEO

June 29, 2007

Mr. Joseph Torti III
Associate Director and Superintendent of Insurance
Department of Business Regulation
Insurance Division
233 Richmond Street
Suite 233
Providence, RI 02903

Dear Mr. Torti:

Please accept this letter and its addendum as The Beacon Mutual Insurance Company's ("Beacon") response to the Market Conduct Examination ("Report") performed under the direction of the Department of Business Regulation ("DBR").

Since the Almond/Giuliani report, initiated by the board of directors of Beacon, was received on April 10, 2006, Beacon's management, staff and directors have prioritized actions to identify and address the issues presented in that report. Additional issues raised internally and during the DBR's examination as outlined in the Report have also been addressed. (The Almond/Giuliani report and the Report are hereafter referred to as "the Reports.") Beacon fully appreciates the importance of the issues raised by the Reports and the need for all these issues to be considered and, where appropriate, addressed.

Since April, 2006, Beacon has developed and initiated 75 corporate improvement projects. The board and management believed it was imperative to start the process of change immediately and believe the work, as documented through these projects, addresses the issues identified in the Reports. As part of this process, Beacon has recognized the importance of working cooperatively with the DBR. Beacon's management, staff and directors are committed to continuing to work with the DBR to address the concerns raised by the Report and to implement changes that will help Beacon continue to provide the employers and workers of the State of Rhode Island with stability, competitive prices and superior workers' compensation coverage and service.

As documented in the Report, Beacon experienced very rapid growth during its initial years of operation. During this period, the company's primary focus was to respond to rapidly increasing service demands and support functions. The Report notes that as a mono-line carrier, Beacon could compete only on price and service and, in response to the return of competition to the marketplace in 1996, Beacon introduced new pricing methodologies and practices. The Report recites that former management directed Beacon's approach to premium pricing, established corporate control centralized in one

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Mr. Joseph Torti III

June 29, 2007

Page 2

executive and created a corporate structure marked by a lack of interaction across operations and departments and the absence of collaboration.

Under the direction of the board of directors since April 2006, significant steps have been taken to improve the company's structure, internal and operating controls and organizational discipline, through development of Beacon's 75 projects and the restructuring of Beacon's management team, including employing a new chief executive officer and appointing a chief operating officer. Beacon will continue to provide insurance coverage at competitive prices to all insureds in Rhode Island. Beacon is committed to providing the exceptional services policyholders, agents and injured workers expect.

Beacon's efforts to improve workplace safety through our loss prevention services have been significant. From 2002 to 2006, the number of reported claims per insured significantly decreased by 34.9%. In addition, Beacon's claims management programs have focused on returning injured workers to gainful employment by providing them with timely and appropriate medical treatment. These loss prevention and claims programs have controlled the rising costs of claims, which were a significant factor in the reduction in the average premium per policy over this period. Furthermore, Beacon's successful results contributed to supporting overall system-wide rate reductions initiated by the National Council of Compensation Insurance ("NCCI"). As a measure of our customer satisfaction, Beacon maintains customer retention in excess of 90%, significantly outperforming industry averages.

Over the past 12 months, Beacon has improved and strengthened our corporate governance structure and operating activities. The senior management team has been evaluated and restructured. Consultants have been retained to assist with the restructuring of operating functions. Significant changes have been made in the composition of our board of directors. The board is committed to, and has operated with, greater transparency. Senior management has increased the level and quality of the documentation of our processes and procedures. Improved audit processes have been developed to help ensure proper procedures are followed and deviations from our policies can be identified and corrected. The recommendations contained in the Reports will help Beacon continue to move forward with improving its operations and structures. Through company-wide efforts made during the past year, 24 of the 79 recommendations in the Report have already been implemented. Beacon considers this as an opportunity to better serve our policyholders.

The Report is lengthy and detailed. While Beacon agrees with many aspects of the Report, the company is concerned with certain comments and themes discussed in the Report. In addition, Beacon's interpretation of certain legal issues differs from the conclusions reached in the Report. The fact that Beacon has not addressed in this response every issue raised in the Report is not an admission or waiver of rights or defenses by Beacon of any kind in this or any other proceeding.



The remainder of this letter presents responses and concerns relating to the following items:

1. Impact on Beacon
2. Alleged statutory violations
3. Factual vs. speculative and subjective comments
4. Competition and pricing patterns

IMPACT ON BEACON

The processes associated with the Reports have had a major impact on Beacon, both financially and operationally. Many of these changes will help Beacon improve its operations and controls, but this process has come at a substantial cost. The direct costs for Deloitte Financial Advisory Service, LLP, Giuliani Security & Safety, LLC, industry experts, internal auditors, attorneys and other consultants have already exceeded \$7.5 million. Beacon expects to incur additional and significant expenses as the recommendations continue to be implemented and open issues related to the Report are resolved. In addition to the direct costs, Beacon's staff, management and directors have dedicated thousands of hours responding to audit inquiries. For example, Beacon has responded to over 370 formal data requests generating tens of thousands of documents. The indirect costs of fulfilling these requests cannot be estimated, but the workload has been staggering.

The discussion concerning the impact on Beacon is not meant to criticize the process or diminish the importance of the results, but rather to provide context to the significant impact it has made on Beacon. Although the process has been difficult and costly, positive changes in the way the "new" Beacon operates have been made. Beacon will continue to provide the excellent loss prevention, claims management and customer services that have helped employers and employees throughout the company's history. Even with the task of responding to the Reports over the past 12 months, Beacon has not lost its focus on these important services and our policyholders.

ALLEGED STATUTORY VIOLATIONS

With the issuance of the Almond/Giuliani report in April, 2006, and the changes in both Beacon's management and board of directors since that time, Beacon has taken its responsibility to address the issues raised by the DBR and others very seriously. To that end, starting in April of 2006 and continuing through this date, Beacon's board and management have worked on developing a system that will implement the recommendations determined externally by the DBR and other examiners as well as those determined internally as part of Beacon's own review process.



Further, Beacon acknowledges that the DBR raises a number of issues with regard to a limited number of policies. While Beacon respectfully disagrees with portions of the legal analysis and conclusions of the Report on several issues, Beacon has taken appropriate measures to comply with the DBR's current interpretation of state law as evidenced by the attached exhibits.

FACTUAL VS. SPECULATIVE AND SUBJECTIVE COMMENTS

The Report contains numerous examples of verified factual issues. In these instances, factual comments made by those interviewed provide insight into the issues addressed in the Report. We are, however, concerned with many of the comments contained in the Report that appear to be speculative or subjective in nature. Beacon is concerned that these comments have been relied upon, or will be interpreted, as fact. A number of these speculative and subjective comments appear to be opinions or conjecture and are not substantiated with specific evidence. Given the substantive issues raised by the Report, Beacon has responded to and focused upon the recommendations contained in the Report and does not believe that it would be productive to respond to or rebut what the company believes are speculative or subjective comments or conclusions.

COMPETITION AND PRICING PATTERNS

Beacon acknowledges and embraces its role as the Rhode Island insurer of last resort. However, in order to provide competitive premiums for all insureds, including the residual market, it is important for Beacon to have economies of scale. Without maintaining the appropriate premium volume, the cost of insurance, particularly for the residual market, would increase and Beacon's services would be reduced. Beacon's services have clearly helped policyholders and the State of Rhode Island and made the workplace safer for many employees. This is evidenced by greater reduction in claims frequency, lower litigation costs per claim, higher policy retention, more loss prevention and claims services and an overall better loss ratio than benchmark averages. Beacon's Charter authorizes Beacon to provide competitive insurance to all employers in Rhode Island, and as the above analysis shows, Beacon's ability to compete in the marketplace is necessary to provide the residual market with competitive rates.

The Report infers that Beacon's market share increased due to improper pricing practices and our opposition to competition. These inferences do not appropriately consider other factors that contributed to Beacon's premium growth. Beacon's premium growth pattern is consistent with the pattern experienced by many of the competitive state workers' compensation insurance funds. Ten of the twenty-two state funds were created during the 1990's when many states were experiencing problems similar to Rhode Island's workers' compensation insurance system. These funds provided stability to a marketplace where historically, larger insurers had entered and exited markets based on profitability. When Beacon's premium history is compared to the ten competitive state workers'



compensation insurance funds that provide public information, the premium volumes are similar in rate of change each year from 1995-2005.

The Report discusses pricing patterns of Beacon's agents/insureds and implies that Beacon's business is disproportionately driven by a small numbers of agents/insureds and does not consider the experience of other insurance companies. Beacon is required, by law, to accept insurance from any licensed agent in Rhode Island. Outside of this exception, the profiles of Beacon's agency force and policyholders are similar to most commercial lines insurance companies.

CONCLUSION

The management, employees and board of directors are committed to improving the operations and controls at Beacon. Beacon has taken many substantive steps in this process as evidenced by the 75 corporate improvement initiatives already underway at Beacon. Beacon has changed for the better, both organizationally and operationally.

Beacon is committed to responding to the Report in a manner that protects its policyholders and Rhode Island's workers' compensation system. It is critical to continue to institute reforms and procedures that will strengthen the company while maintaining the ability to compete in the marketplace. Beacon recognizes and welcomes an equal playing field for all companies to create fair competition.

Beacon is also committed to working with the Department to ensure this response is thorough, exhaustive and accurate. The Rhode Island business community deserves nothing less. Beacon would appreciate the opportunity to share these observations with the DBR and hopes to work together to resolve these issues and conclude this process.

Sincerely,

James V. Rosati
President and Chief Executive Officer