COMMERCE GROUP INC /MA
Form S-3
September 29, 2003

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As filed with the Securities and Exchange Commission on September 29, 2003

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form S-3

REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

The Commerce Group, Inc.

(Exact name of registrant as specified in its charter)

Massachusetts	**04-2599931**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*

211 Main Street

Webster, MA 01570
(508) 943-9000
(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

James A. Ermilio

Senior Vice President and General Counsel
The Commerce Group, Inc.
211 Main Street
Webster, MA 01570
(508) 943-9000
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

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(617) 310-9000 (facsimile)	**(212) 455-2502 (facsimile)**

Approximate date of commencement of proposed sale to the public:
As soon as practicable after the effective date of this Registration Statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price Per Unit(1)	Proposed Maximum Aggregate Offering Price(1)	Amount of Registration Fee
% Senior Notes due	$300,000,000	100%	$300,000,000	$24,270

(1) Estimated solely for the purpose of calculating the registration fee.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment that specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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SUBJECT TO COMPLETION, DATED SEPTEMBER 29, 2003

PRELIMINARY PROSPECTUS

$300,000,000

The Commerce Group, Inc.

% Senior Notes due

We are offering $300,000,000 of % senior notes due , . The notes will mature on , . We will pay interest on the notes on and of each year. The first interest payment on the notes will be made on , 2004. We may redeem the notes, in whole or in part, at the redemption prices described in this prospectus.

The notes will be senior obligations of our company and will rank on a parity with all of our future unsecured and unsubordinated indebtedness. As of the date of this prospectus, we do not have any indebtedness.

See Risk Factors beginning on page 6 to read about risks you should consider before buying the notes.

	Per Note	Total
Public offering price(1)	$	$
Underwriting discounts and commissions	$	$
Proceeds, before expenses, to us	$	$

(1) Interest on the notes will accrue from , 2003 to date of delivery.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Delivery of the notes in book-entry form only through The Depository Trust Company will be made on or about , 2003.

Joint Book-Running Managers

Bear, Stearns & Co. Inc.

Merrill Lynch & Co.

The date of this prospectus is , 2003.

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You should only rely on the information contained or incorporated by reference in this prospectus. We have not authorized anyone to provide you with different information. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted. You should not assume that the information contained or incorporated by reference in this prospectus is accurate as of any date other than the date on the cover of the prospectus, regardless of the time of delivery of the prospectus or any sale of the notes.

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PROSPECTUS SUMMARY

This summary highlights information contained elsewhere in this prospectus and in the documents incorporated by reference. Because this is a summary, it does not contain all of the information that may be important to you. You should read the entire prospectus and the documents incorporated by reference carefully before you decide to invest in the notes. In this prospectus, Commerce Group refers to The Commerce Group, Inc., and Commerce, we, us, and our refer collectively to Commerce Group and its consolidated subsidiaries.

Our Business

We provide personal and commercial property and casualty insurance in Massachusetts and, to a lesser extent, in 27 other states. We market our products exclusively through our network of independent agents, including 628 agents in Massachusetts, 30 agents in New Hampshire, 808 agents in California and Oregon, and 32 agents in 26 other states. Our core product lines are personal automobile, homeowners, and commercial automobile insurance. We have been the largest writer of personal property and casualty insurance in Massachusetts in terms of direct premiums written since 1990. In addition to our core product lines, we write commercial multi-peril, inland marine, fire, general liability, and personal and commercial umbrella insurance. On a consolidated basis, we were ranked the 22nd largest personal automobile insurance group in the country by A.M. Best, based on direct premiums written as of December 31, 2002. The following table presents our direct premiums written in 2002:

	Massachusetts	All Other States	Total	% of Total
		(Dollars in thousands)		
Personal Automobile	$ 1,032,438	$ 155,045	$ 1,187,483	84.4%
Homeowners	87,634	27,376	115,010	8.2
Commercial Automobile	74,879	5,151	80,030	5.7
Other Lines	23,569	764	24,333	1.7
Total	$ 1,218,520	$ 188,336	$ 1,406,856	100.0%

In 2002, Massachusetts was the 11th largest property and casualty insurance market in the United States, with $10.3 billion in direct premiums written, according to A.M. Best & Co. Our market share for each of our core product lines in Massachusetts, based on direct premiums written, has increased during the period from 1998 through 2002, from 22.6% to 25.7% for personal automobile insurance, from 7.2% to 8.2% for homeowners insurance and from 7.0% to 9.9% for commercial automobile insurance. Our market share for Massachusetts personal automobile insurance has increased to 27.3% as of June 30, 2003, and we believe that our market share for each of our other core product lines in Massachusetts also has continued to increase in 2003.

In addition to increasing our market share in our core product lines, we have also reported underwriting results, growth in net premiums written, and investment returns that were superior to those of the property and casualty insurance industry as a whole for the five-year period ended December 31, 2002, as reported by A.M. Best. Our underwriting results and premium growth have surpassed industry averages in every year since 1998. For the five-year period ended December 31, 2002, we achieved an average annual statutory combined ratio of 98.2%, which is lower than the 106.0% average for the property and casualty insurance industry, which we have adjusted to reflect our relative product mix as shown in the preceding table.

Our net earnings for the six months ended June 30, 2003 were $84.4 million, compared to net earnings of $32.7 million for the six months ended June 30, 2002. The increase in net earnings resulted primarily from a $68.1 million after-tax increase in our realized investment gains to $42.9 million after-taxes for the six months ended June 30, 2003 compared to a realized investment loss of $25.2 million after-taxes for the comparable period of 2002. Our net realized investment gains increased primarily because of:

- a change in our investment strategy to shorten the overall duration of our investment portfolio; and

- the favorable impact of the decline in interest rates during the second quarter on the net asset value of seven closed-end preferred stock mutual funds that we were required to categorize as realized investment gains using the equity method of accounting.

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As of the date of this prospectus, we own four fund investments that we account for using the equity method. If, as we expect, long-term interest rates are higher at September 30, 2003 than they were at June 30, 2003, the respective net asset values of those funds as of September 30, 2003 would be less than they were at June 30, 2003, and we would recognize a net realized investment loss for those four fund investments that may have a material adverse effect on our results of operations for the period ending September 30, 2003. See Management s Discussion and Analysis of Financial Condition and Results of Operations.

Our Strengths

We attribute our financial and underwriting success primarily to the following factors:

We have a highly experienced management team with a proven track record.

We have been the largest writer of personal property and casualty insurance in Massachusetts in terms of direct premiums written since 1990.

We have achieved economies of scale in Massachusetts which we believe provides us with an expense advantage.

We have an in-depth understanding of the Massachusetts underwriting environment and its complex regulatory system as a consequence of our long history of primarily serving the Massachusetts market and focusing on automobile insurance.

We have strong relationships with independent agencies that provide quality business to us. We focus on carefully selecting and retaining agencies that can generate a sizable volume of business with favorable underwriting characteristics.

We are a leader in affinity group marketing arrangements. We have agreements with the four AAA clubs in Massachusetts that make us the exclusive underwriter of personal automobile insurance for their affinity group marketing programs. In 2002, $619 million, or 44.0%, of our total direct premiums written were attributable to our affinity group marketing arrangements with these AAA clubs.

We maintain advanced information systems with an extensive underwriting database, which we believe enables us both to manage our underwriting risks better than many other companies in Massachusetts and to better support our agencies.

We believe that our history of maintaining a strong financial condition gives us an advantage in attracting and retaining quality business and agents. We currently have an A.M. Best group rating of A+ (Superior), and we have had a group rating of A (Excellent) or better since 1993.

Our Strategy

Our primary business strategy is to continue to focus on the personal automobile insurance market in Massachusetts and to enhance our geographic diversity by increasing the proportion of our business that originates outside of Massachusetts. We expect to invest a substantial portion of the offering proceeds to enhance the capital position of our insurance operating subsidiaries in support of recent premium growth, as well as to continue diversification efforts outside of Massachusetts by our existing subsidiaries. We expect to continue to pursue our long-term objective of furthering our relationship with the AAA clubs and expanding our personal automobile and homeowners insurance businesses into other states where we believe the independent agent distribution channel is strong.

Contact Information

Our principal executive office is located at 211 Main Street, Webster, MA 01570. Our telephone number is (508) 943-9000. See Where You Can Find More Information; Incorporation by Reference.

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Summary of the Offering

The following is a brief summary of this offering. For a more complete description of the notes, see Description of the Notes in this prospectus.

Issuer	The Commerce Group, Inc.
Notes offered	$300,000,000 of % senior notes due .
Maturity	The notes will mature on , .
Interest payment dates	and , beginning , 2004.
Optional redemption	We may redeem the notes at our option at any time, in whole or in part, in exchange for payment to you of a specified amount. See Description of the Notes Optional Redemption for a description of the calculation of the amount you will receive upon a redemption of your notes. We are not required to establish a sinking fund to retire the notes prior to maturity.
Ranking	The notes are unsecured and unsubordinated and will rank on a parity with all of our existing and future unsecured and unsubordinated indebtedness.
Covenants	The indenture for the notes contains limitations on liens on and sales of common stock of our designated subsidiaries (as defined in the indenture). These covenants are subject to important qualifications and limitations.
Use of proceeds	We estimate that the net proceeds of this offering will be $ million, based on an assumed public offering price of $ per note. We expect to use the net proceeds from this offering for general corporate purposes, including to enhance the capital position of our insurance operating subsidiaries in support of recent premium growth, as well as to continue diversification efforts outside of Massachusetts by our existing subsidiaries. See Use of Proceeds.
Risk Factors	See Risk Factors beginning on page 6 for a description of risks that you should consider before you decide to invest in the notes.

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Summary Consolidated Financial Data

The data below should be read in conjunction with the consolidated financial statements, related footnotes, and other financial information included or incorporated by reference in this prospectus. The financial statements for the three years ended December 31, 2002 have been audited by Ernst & Young LLP. The data presented below as of and for the six months ended June 30, 2003 and for the six months ended June 30, 2002 are derived from our unaudited condensed consolidated financial statements appearing elsewhere in this prospectus. Such unaudited condensed consolidated financial statements have been prepared on the same basis as our audited consolidated financial statements and, in our opinion, include all adjustments, which consist only of normal recurring adjustments, necessary for a fair presentation of our financial condition and results of operations. Operating results for the six month period ended June 30, 2003 are not necessarily indicative of the results that may be expected for the entire year ending December 31, 2003.

	Six Months Ended June 30,		Year Ended December 31,		
	2003	2002	2002	2001	2000
	(Dollars in thousands)				
	(Unaudited)				
		(Restated)		(Restated)	
Statement of Earnings Data:					
Direct premiums written	$864,581	$731,929	$1,406,856	$1,152,407	$1,071,649
Net premiums written	$812,510	$702,037	$1,313,014	$1,078,967	$1,008,911
Earned premiums	$688,256	$577,174	$1,210,040	$1,043,652	$ 954,483
Net investment income	45,812	47,762	98,466	99,563	96,830
Premium finance and service fees	13,245	9,997	21,498	17,819	15,227
Amortization of excess of book value of subsidiary interest over cost				3,389	3,390
Net realized investment gains (losses)	60,020	(34,992)	(82,385)	(10,633)	29,550
Other income		7,000	9,500		
Total revenues	$807,333	$606,941	$1,257,119	$1,153,790	$1,099,480
Earnings before income taxes, minority interest and change in accounting principle	$107,958	$ 25,318	$ 52,026	$ 107,782	$ 170,066
Income taxes	23,485	4,048	17,063	18,392	38,306
Net earnings before minority interest and change in accounting principle	84,473	21,270	34,963	89,390	131,760
Minority interest in net (earnings) loss of subsidiary	(80)	163	555	863	320
Net earnings before change in accounting principle	84,393	21,433	35,518	90,253	132,080

Change in accounting principle, net of taxes		11,237	11,237		
Net earnings	$ 84,393	$ 32,670	$ 46,755	$ 90,253	$ 132,080
Comprehensive income	$ 91,482	$ 46,336	$ 59,625	$ 90,814	$ 168,570

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	Six Months Ended June 30,		Year Ended December 31,		
	2003	2002	2002	2001	2000
	(Unaudited)				
		(Restated)		(Restated)	
Statement of Earnings Data:					
Net earnings per common share before cumulative effects of change in accounting principle:					
Basic	$ 2.64	$ 0.65	$ 1.08	$ 2.69	$ 3.87
Diluted	$ 2.62	$ 0.64	$ 1.08	$ 2.67	$ 3.87
Net earnings per common share from the cumulative effects of change in accounting principle:					
Basic	$	$ 0.34	$ 0.34	$	$
Diluted	$	$ 0.34	$ 0.34	$	$
Net earnings per common share:					
Basic	$ 2.64	$ 0.99	$ 1.43	$ 2.69	$ 3.87
Diluted	$ 2.62	$ 0.98	$ 1.42	$ 2.67	$ 3.87
Cash dividends per share	$ 0.63	$ 0.61	$ 1.23	$ 1.19	$ 1.15
Weighted average number of common shares outstanding:					
Basic	31,986,847	33,025,426	32,773,519	33,608,804	34,121,047
Diluted	32,187,013	33,355,669	33,028,081	33,794,938	34,121,047
Other Data and Ratios:					
Ratio of earnings to fixed charges (based on GAAP)(1)	2,400.1x	N/A	554.5x	1,135.5x	1,829.7x
Net premiums written to policyholders surplus	211.7%(2)	179.5%(2)	198.3%	150.7%	152.6%
Statutory loss and LAE ratio	78.7%	75.7%	75.1%	74.5%	71.7%
Statutory underwriting expense ratio	21.3%	22.7%	23.6%	24.2%	25.1%
Statutory combined ratio	100.0%	98.4%	98.7%	98.7%	96.8%

At December 31,

	At June 30, 2003	2002	2001	2000
		(Dollars in thousands, except per share data)		
	(Unaudited)		(Restated)	
Balance Sheet Data:				
Total investments at market value and equity value	$1,751,649	$1,577,070	$1,498,201	$1,472,562
Total assets	2,729,382	2,382,688	2,154,631	2,075,614
Total liabilities	1,869,228	1,588,530	1,345,198	1,292,665
Minority interest	4,228	4,106		1,068
Total stockholders equity	855,926	790,052	809,433	781,881
Total stockholders equity per share	$ 26.79	$ 24.60	$ 24.43	$ 23.16

(1) We have computed the ratio of earnings to fixed charges by dividing earnings before income taxes plus fixed charges by fixed charges. Fixed charges consist of the portion of rents representative of the interest factor.

(2) For the twelve months ended June 30, 2003 and 2002, respectively. This data is not available for six-month periods.

RISK FACTORS

Before you invest in the notes, you should carefully consider the risks involved. Accordingly, you should carefully consider the information contained or incorporated by reference in this prospectus, including the risk factors listed below. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently believe to be immaterial may also adversely affect our business. If any of the following risks or uncertainties develops into an actual event, it could have a material adverse effect on our business, financial condition or results of operations and could adversely affect the value of the notes.

Risks Related to Our Business

We are primarily a personal automobile insurance carrier, and therefore our business may be adversely affected by conditions in this industry.

Approximately 84.4% of our direct premiums written for the year ended December 31, 2002 were generated from personal automobile insurance policies. As a result of our focus on that line of business, negative developments in the economic, competitive or regulatory conditions affecting the personal automobile insurance industry could have a material adverse effect on our results of operations and financial condition. Factors that negatively affect cost trends and our profitability include inflation in automobile repair costs, automobile parts costs, used car prices and medical care. Increased litigation of claims may also adversely affect loss costs. In addition, these developments in the personal automobile insurance industry would have a disproportionate effect on us, compared to insurers which are more diversified across multiple business lines.

We write a substantial portion of our business in Massachusetts, and therefore our business may be adversely affected by conditions and adverse judicial decisions in Massachusetts.

Approximately 86.6% of our direct premiums written for the year ended December 31, 2002 were generated in Massachusetts. Our revenues and profitability are therefore subject to prevailing regulatory, economic, demographic, competitive and other conditions, including weather-related events as described below, and adverse judicial decisions in Massachusetts. Changes in any of these conditions or the rendering of an adverse judicial decision could make it more costly or difficult for us to conduct our business. In addition, these developments would have a disproportionate effect on us, compared to insurers that do not have such a geographic concentration. For a discussion of risks related to regulatory developments, see We are subject to comprehensive regulation by Massachusetts as well as the other states in which we operate, and our ability to earn profits may be restricted by these regulations.

Our financial performance may be materially adversely affected by severe weather conditions or other catastrophic losses.

We are exposed to the risk of severe weather conditions and other catastrophes. Catastrophes can be caused by natural events, such as hurricanes, coastal storms, severe ice or snow storms, tornadoes, windstorms, earthquakes, hailstorms and fires, and man-made events, such as explosions, terrorist attacks or riots. The incidence and severity of such catastrophes are inherently unpredictable and our losses from catastrophes could be substantial. The occurrence of claims from catastrophic events is likely to result in substantial volatility in our financial condition or results of operations for any fiscal quarter or year and could have a material adverse effect on our financial condition or results of operations and our ability to write new business. This volatility is compounded by accounting regulations that do not permit reinsurers to reserve for such catastrophic events until they occur.

The occurrence of severe weather conditions is inherently unpredictable. There is generally an increase in claims frequency and severity under the personal automobile insurance we write when severe weather occurs because of a higher incidence of vehicular accidents and other insured losses tend to occur as a result of severe weather conditions. We do not carry reinsurance for physical damage or comprehensive catastrophic-related losses for our personal or commercial automobile product lines.

In addition, we have exposure to an increase in claims frequency and severity under the homeowners and other property insurance we write because property damage may result from severe weather conditions. Some catastrophes are restricted to small geographic areas; however, hurricanes, coastal storms, tornadoes, winter storms, windstorms, earthquakes, terrorist attacks and other man-made catastrophes may produce significant damage over large, heavily populated areas. Although we participate in a quota share reinsurance program to limit our exposure to these types of natural catastrophes, we would have no reinsurance recoveries for a single event catastrophe to the extent that the total loss exceeds $347 million. This calculation is based on the annual estimated amount of premiums subject to the new 65% quota share reinsurance program effective July 1, 2003. Several limitations were added to the new quota share program regarding losses related to nuclear, chemical and biological terrorist events. Our maximum loss recovery in case of these types of events is estimated at $26 million. Although we attempt to manage our exposure to such events, a single catastrophic event could affect multiple geographic zones or the frequency or severity of catastrophic events could exceed our estimates. As a result, the occurrence of one or more catastrophic events could have a material adverse effect on our financial condition or results of operations.

We are part of a joint underwriting association that provides excess loss coverage to nuclear power plants and related facilities. Our maximum exposure in the event of a catastrophic loss at an insured nuclear facility is $5.0 million.

If we are not able to attract and retain independent agents, it could adversely affect our business.

We market our insurance solely through independent agents. We must compete with other insurance carriers for the business of independent agents. Additionally, most agents represent more than one company, which means we face competition within each agency. Some of our competitors offer a larger variety of products, lower prices for insurance coverage or higher compensation. While we believe that the compensation and services we provide to our agents are competitive with other insurers, changes in compensation, services or products offered by our competitors could make it harder for us to attract and retain independent agents to sell our insurance products.

If our affinity relationship with the AAA Clubs of Massachusetts were to be terminated, our sales of personal automobile insurance products may decline, which would adversely affect our business and results of operations.

Since 1995 we have actively pursued affinity group marketing programs, which provide participating groups with a means of purchasing discounted private passenger automobile insurance through associations and employer groups. Our largest agreements are with the four American Automobile Association Clubs in Massachusetts, to which $619.0 million, or 44.0%, of our direct premiums written were attributable in 2002. In addition, 13.5% of our total Massachusetts automobile exposures written through the AAA affinity group marketing program were written through insurance agencies owned by the AAA clubs. We are the exclusive underwriter of Massachusetts personal automobile group programs for those AAA clubs. We have a rolling three-year contract with each of these AAA clubs that may be terminated by the AAA club upon a minimum of three years written notice. Should one or more of these AAA clubs elect to terminate those exclusive agreements, we would lose a significant avenue for offering affinity discounts, and we may not be able to achieve comparable sales through different affinity programs or otherwise. We also expect that we would lose the business written through any insurance agency owned by a AAA club that elects to terminate its exclusive arrangement with us. In addition, the AAA insurance agency in Massachusetts that writes the greatest amount of our business, accounting for $79.8 million of direct premiums written in 2002, is controlled by the same AAA club that controls the Rhode Island AAA insurance agency. In 2002, that Rhode Island AAA insurance agency produced $16.9 million of direct premiums written for our subsidiary American Commerce, representing 1.2% of our total direct premiums written for that year. If the AAA insurance agency in Massachusetts that is affiliated with the Rhode Island AAA insurance agency were to terminate its exclusive arrangement with us, we expect that American Commerce would likely lose its Rhode Island business as well. For these reasons, the termination of our exclusive arrangement with one or more of the AAA clubs may have an adverse effect on our business and results of operations.

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If American Commerce s relationship with one or more large AAA clubs terminates, then American Commerce would lose a substantial portion of its business, which could have a material adverse effect on our business and results of operations.

American Commerce s business is concentrated in several states. In 2002, the direct premiums written produced from the state where American Commerce has the largest concentration totaled $30.4 million, representing 21.8% of American Commerce s direct premiums written and 2.2% of our total direct premiums written for that year. Direct premiums written by American Commerce in the top six states in which American Commerce does business represented $107.1 million, or 77.0% of American Commerce s direct premiums written and 7.6% of our total direct premiums written in 2002. Furthermore, all of American Commerce s business in each of these states is generated by one or more insurance agencies owned by a single AAA club in that state, with limited exceptions. Therefore, if American Commerce s relationship with one or more of these AAA clubs terminates, then American Commerce would likely lose a substantial portion of its business, and that loss of business could have a material adverse effect on our results of operations.

Established competitors with greater resources may make it difficult for us to market our products effectively and offer our products at a profit.

We compete with various regional and domestic insurers, national agency companies and direct writers. Some of these competitors have financial resources greater than ours. Any of these competitors could undertake actions which could adversely affect our profitability, such as pricing automobile insurance premiums more aggressively or offering greater compensation to independent agencies. According to A.M. Best, we were the largest writer of personal automobile insurance in Massachusetts in 2002, with a 25.7% share of direct premiums written. By comparison, the second, third and fourth largest writers of personal automobile insurance in Massachusetts had shares of direct premiums written of 10.6%, 10.5% and 7.6%, respectively, in 2002, according to A.M. Best.

We believe the Massachusetts regulatory environment, which

- requires personal automobile insurers to issue a policy to any eligible applicant who seeks one, known as the take all comers law,
- fixes maximum personal automobile rates, which has the effect of keeping premiums artificially low on specific high risk segments of the market, such as urban and youthful drivers, effectively imposing higher premiums on lower risk segments,
- assigns certain agents that have not been able to obtain a voluntary contract with another insurer, known as Exclusive Representative Producers, or ERPs, to servicing carriers on the basis of market share,
- apportions losses incurred by the state-mandated residual market run by Commonwealth Automobile Reinsurers, known as CAR,
- mandates that higher compulsory and optional coverages be offered to all eligible drivers, and
- establishes minimum agency commissions,

has discouraged certain companies with more traditional underwriting and pricing approaches from establishing a presence or expanding their market share in Massachusetts. Changes in prevailing regulatory policies could adversely affect our competitive position. We cannot assure you that such changes will not occur.

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We are subject to comprehensive regulation by Massachusetts as well as the other states in which we operate, and our ability to earn profits may be restricted by these regulations.

General Regulation. We are subject to regulation by government agencies in Massachusetts, as well as in the other states in which we operate, and we must obtain prior approval for certain corporate actions. In Massachusetts, for example, we must comply with regulations involving:

mandatory underwriting, commonly known as take-all-comers regulations;

transactions between an insurance company and any of its affiliates;

the payment of dividends;

the acquisition of an insurance company or of any company controlling an insurance company;

approval or filing of premium rates and policy forms;

solvency standards;

minimum amounts of capital and surplus which must be maintained;

limitations on types and amounts of investments;

restrictions on the size of risks which may be insured by a single company;

limitation of the right to cancel or choose not to renew policies in some lines;

regulation of the right to withdraw from markets or terminate involvement with agencies;

requirements to participate in residual markets, such as CAR, or other state-mandated insurance pools;

licensing of insurers and agents;

deposits of securities for the benefit of policyholders; and

reporting with respect to financial condition.

The other states in which we operate have similar regulations. In addition, insurance department examiners from Massachusetts, California and Ohio perform periodic financial and market conduct examinations of insurance companies. Such regulation is generally intended for the protection of policyholders rather than security holders.

Massachusetts requires that all licensed property and casualty insurers bear a portion of the losses suffered by some insureds as a result of impaired or insolvent insurance companies. In 2002 and 2001, we were assessed $4.5 million and $3.1 million, respectively, as our portion of these losses primarily due to the insolvencies of The Trust Insurance Company, New England Fidelity, and Credit General Insurance Company. In addition, Massachusetts has established an underwriting association in order to ensure that property insurance is available for owners of high risk property who are not able to obtain insurance from private insurers. The losses of this underwriting association are shared by all insurers that write property and casualty insurance in Massachusetts. We are assessed from time to time to pay those losses. The effect of these assessments could reduce our profitability in any given period and limit our ability to grow our business. Additionally, Commerce West and American Commerce are domiciled in California and Ohio, respectively, and are both covered by similar associations in the states where they do business. These associations operate similarly to the Massachusetts association described above.

We are unable to predict changes in the political, economic or regulatory environments in Massachusetts and other states in the future. We cannot assure you that existing insurance-related laws and regulations will not become more restrictive in the future or that new restrictive laws will not be enacted, and we cannot predict the potential effects on us of any such laws and regulations.

Massachusetts Personal Automobile Insurance Regulation; Commonwealth Automobile Reinsurance Program. We are subject to the extensive regulation of the private passenger automobile insurance industry in Massachusetts, and our ability to earn profits may be restricted by these requirements. Owners of automobiles are required to demonstrate minimum automobile insurance coverage prior to registration. Generally, we are required by law to issue a policy to any applicant who seeks it. On the basis of our market share, we are assigned ERPs. In addition, we are required to participate in the state-mandated reinsurance program run by CAR, to which we may cede risks that we believe are underpriced and from which we are allocated a portion of the program s overall losses. Since its inception, CAR has annually generated hundreds of millions of dollars in underwriting losses, primarily in the personal pool. All companies underwriting automobile insurance in Massachusetts share in the underwriting results of the CAR business for their respective product line or lines. A company s proportionate share of the CAR personal or commercial deficit is based on its market share of the automobile risks for the particular pool, adjusted by a utilization formula such that, in general, a company s participation ratio is disproportionately and adversely affected if its relative use of CAR reinsurance exceeds that of the industry, and favorably affected if its relative use of CAR reinsurance is less than that of the industry. Finally, for the personal automobile CAR pool, an insurer s participation ratio may be affected by credits received for not reinsuring through CAR automobile risks in selected underpriced classes and territories. An insurer s participation ratio will be favorably affected if its relative use of credits exceeds that of the Massachusetts industry. Credit values are set annually by CAR, and we cannot forecast whether the yearly changes will be beneficial or detrimental to the results of our personal automobile insurance business.

Member companies of CAR have joint and several liabilities for the obligations of CAR. If one member of CAR fails to pay its assessments, each of the remaining members of CAR will be required to pay its pro-rata share of the member who fails to pay its obligations. As a result of the concentration of the Massachusetts market for personal automobile insurance, the assessment could have a material adverse effect on our results of operations if one of the leading companies were to fail. At the present time, we are not aware of any CAR member company who has failed to meet its obligations.

Proposals to change certain of CAR s rules are under consideration. In a letter to the Commissioner of Insurance of Massachusetts, whom we refer to as the Commissioner, dated June 25, 2002, the Massachusetts Attorney General reported that his office has determined that CAR s current methodology for assigning ERPs and distributing the CAR deficit is not fair and equitable. The Attorney General s letter describes several factors that he believes support his findings and which he believes should be corrected in order to comply with Massachusetts law governing CAR. The Attorney General s letter calls on the Commissioner to work with him to address these issues. The letter has engendered discussion and dialogue among various parties, including the Division of Insurance, that could result in material changes to CAR s rules. It is uncertain when, whether and to what extent the issues raised by the Attorney General will be addressed by the Commissioner. We cannot be certain whether any changes, if adopted by CAR, would affect our profitability.

Massachusetts Rate and Commission Regulation. Our marketing and underwriting strategies are limited by maximum premium rates and minimum agency commission levels for personal automobile insurance, which are mandated by the Commissioner. Rate decisions by the Commissioner are based upon claims experience and other data which are several years old and may not reflect current conditions. If the information considered does not accurately predict the future benefit and expense costs of insurers, or if the Commissioner otherwise sets inadequate premium rates, our future profitability could be decreased. Future increases in commission rates would also decrease our profitability without corresponding increases in premiums.

If we lose certain key personnel, or are unable to attract and retain talented employees and executives, our ability to conduct business successfully could be hindered.

Our future success depends significantly upon the continued contributions of certain key management personnel. We have employed Arthur J. Remillard, Jr., our Chairman, President and Chief Executive Officer, for 31 years and Gerald Fels, our Executive Vice President and Chief Financial Officer, for 28 years. We have employed our other executive officers for an average of 12.4 years each. We do not have employment agreements with any of our executive officers, nor do we have key man life insurance policies covering them. The loss of the services and the institutional knowledge of any one of these officers could adversely affect our business and harm our results of operations and financial condition. Additionally, our ability to continue

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profitable growth and to remain a competitive force in the marketplace depends, in part, on our ability to hire and retain talented employees.

New claim, coverage and regulatory issues in the insurance industry may adversely affect us.

As insurance industry practices and regulatory, judicial, and consumer conditions change, unexpected and unintended issues related to claims, coverage and underwriting may emerge. The issues can have a negative effect on our business by either extending coverage beyond our underwriting intent or by increasing the size of claims. Recent examples of emerging claims, coverage and underwriting issues include:

- a growing trend of plaintiffs targeting automobile insurers in purported class action litigation relating to claims-handling practices such as total loss evaluation methodology and cases alleging that insureds are entitled to recover the inherent diminution in the value of their vehicles involved in accidents;

- increases in the number and size of water damage claims, including those related to expenses for testing and remediation of mold conditions;

- the use of an applicant s credit rating as a factor in making risk selection and pricing decisions; and

- the availability of coverages which pay different commission levels to agents depending upon premium level.

The effects of these and other unforeseen emerging claim, coverage and underwriting issues could negatively affect our results of operations or our methods of doing business.

Regulatory changes to enhance competition in Massachusetts are being considered and, if enacted, could adversely affect our market share and profitability.

From time to time, the Massachusetts Division of Insurance considers potential changes and reforms to the Massachusetts personal automobile insurance system that would have the goal of enhancing competition. For example, in May 2003, the Division held a hearing on changes to the system and solicited comments from the public, though it announced in August 2003 that no reforms would be implemented for 2004 as a result of that review. We are unable to predict what, if any, changes to the regulatory system the Division may implement, and therefore are unable to determine whether the impact would be favorable or unfavorable to us, and the effect, if any, that it would have on competition, nor can we predict when any changes would take effect.

We may enter new markets, and we cannot assure you that our diversification strategy will be effective.

Although we expect that our primary focus will continue to be on our core businesses in Massachusetts and the other states in which we are currently doing business, we have sought and may continue to seek to take advantage of opportunities to expand our core businesses into other states where we believe the independent agent distribution channel is strong. As a result of a number of factors, including the difficulties of finding appropriate expansion opportunities and the challenges of operating in an unfamiliar market, we may not be successful in finding opportunities to expand into other states or in exploiting opportunities we have identified. Further, there can be no assurance that our previous expansion efforts will ultimately be successful.

Our failure to maintain a commercially acceptable financial strength rating would significantly and negatively affect our ability to implement our business strategy successfully.

An important factor in an insurer s ability to compete effectively is its financial strength rating. A.M. Best generally is considered to be a leading authority on insurance company ratings and information. A.M. Best assigns 15 ratings to insurance companies, which currently range from A++ (Superior) to F (in liquidation). A.M. Best has currently assigned Commerce Insurance and Citation, our Massachusetts property and casualty insurance subsidiaries, a combined A+ (Superior) rating. According to A.M. Best, an insurer with a Superior rating has, in A.M. Best s opinion, a superior ability to meet its ongoing obligations to policyholders. Commerce West and American Commerce currently have ratings of A (Excellent). An insurer with an Excellent rating has, in A.M. Best s opinion, an excellent ability to meet its ongoing obligations to policyholders. On May 22, 2003, we were notified by A.M. Best that American Commerce was assigned a rating of A (Excellent) with a negative rating outlook. If American Commerce is subsequently downgraded to below A- (Excellent), American Commerce s standing in the marketplace would be negatively impacted, which would adversely affect its volume of premiums written and ultimately our financial condition and results of operations. For the year ended December 31, 2002, American Commerce wrote $139.2 million in direct premiums, which amounted to 9.9% of our overall direct premiums written for that period.

Moody s Investor Service also rates the financial strength of insurance companies, and has assigned an A2 (Good) rating to Commerce Insurance. According to Moody s, an insurer with an A2 (Good) rating offers good financial security, with elements present which suggest a susceptibility to impairment sometime in the future. Moody s assigns these ratings to insurance companies, which currently range from Aaa to C, with a numerical modifier in each generic rating classification to refer to the ranking in the group, with 1 being the highest and 3 being the lowest. Both Moody s and A.M. Best base their ratings on factors that concern policyholders and not upon factors concerning investor protection. Such ratings are subject to change and are not recommendations to buy, sell or hold securities. Any future decrease in the ratings of one of our subsidiaries could affect our competitive position.

In addition, reinsurance companies and financial institutions use the A.M. Best and other insurance ratings to help assess the financial strength and quality of insurance companies. A decline in the ratings of our property and casualty insurance subsidiaries may dissuade a reinsurance company or financial institution from conducting business with us or increase our reinsurance or interest costs.

Our losses and loss adjustment expenses may exceed our reserves, which could adversely affect our results of operations and financial condition.

The reserves for losses and loss adjustment expenses, or LAE, that we have established are estimates of amounts needed to pay reported and unreported claims and related expenses based on facts and circumstances known to us as of the time we established the reserves. Reserves are based on historical claims information, industry statistics and other factors. The establishment of appropriate reserves is an inherently uncertain process. This uncertainty arises from a number of factors, including the difficulty in predicting the rate of inflation and the rate and direction of changes in trends, interpretation of insurance policy provisions by courts, inconsistent decisions in lawsuits regarding coverage and expanded theories of liability. In addition, changes in claims settlement practices can lead to changes in loss payment patterns, which are used to estimate reserve levels. There can be no assurance that our ultimate liability will not materially exceed our reserves.

Due to the inherent uncertainty of estimating reserves, it has been necessary, and will over time continue to be necessary, to revise estimated future liabilities as reflected in our reserves for claims and policy expenses. If our reserves subsequently are found to be inadequate and therefore must be strengthened, we would be required to treat the amount of such increase as a charge to our earnings in the period that the deficiency is recognized, which would have an adverse effect on our results of operations and financial condition.

The historic development of reserves for losses and loss adjustment expenses may not necessarily reflect future trends in the development of these amounts. Accordingly, it is not appropriate to extrapolate redundancies or deficiencies based on historical information.

Market fluctuations and changes in interest rates have had, and may continue to have, significant and negative effects on our investment portfolio.

Our results of operations depend in part on the performance of our invested assets. We seek to manage our investment portfolio in a manner consistent with the needs of our insurance operations; however, there can be no assurance that we will be successful in this regard. We had fixed-income, preferred stock and

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preferred stock mutual fund investments with a market and equity value of $1.53 billion at June 30, 2003 that are subject to:

- market value risk, which is the risk that our invested assets will decrease in value, due to a change in the prevailing market yields on our investments, an unfavorable change in the liquidity of an investment or an unfavorable change in the financial prospects or a downgrade in the credit rating of the issuer of an investment or one or more other factors;

- reinvestment risk, which is the risk that interest rates will decline, an investment will be redeemed and we will not be able to reinvest the proceeds in a comparable investment that provides a yield equal to or greater than the investment which was redeemed; and

- liquidity risk, which is the risk that we may have to sell assets at an undesirable time and/or price to provide for payment of claims.

In addition, our investment portfolio is subject to risks inherent in the domestic and international capital markets. The functioning of those markets, the value of our investments and our ability to liquidate investments on short notice may be adversely affected if those markets are disrupted by national or international events including, without limitation, wars, terrorist attacks, recessions or depressions, high inflation or a deflationary environment, the collapse of governments or financial markets, and other factors or events.

Our fixed-income investment portfolio includes mortgage-backed and other asset-backed securities. As of June 30, 2003, mortgage-backed securities and other asset-backed securities constituted approximately 13.7% of our cash and invested assets. As with other fixed income investments, the fair value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose us to prepayment risks on these investments. In periods of declining interest rates, mortgage prepayments generally increase and mortgage-backed securities and other asset-backed securities are paid more quickly, requiring us to reinvest the proceeds at the then current market rates.

We seek to maintain a proper amount of diversity and liquidity in our portfolio; however, there can be no assurance that we will be successful in this regard. If our portfolio were to be impaired by market or issuer-specific conditions to a substantial degree, our liquidity, financial position and financial results could be materially adversely affected. Further, our income from these investments could be materially reduced, and write-downs of the value of certain securities could further reduce our profitability. In addition, a decrease in value of our investment portfolio could put our subsidiaries at risk of failing to satisfy regulatory capital requirements. If we were not at that time able to supplement our capital by issuing debt or equity securities on acceptable terms, our ability to continue growing could be adversely affected.

Interest rates in the United States are currently low relative to recent historical levels. Based on data compiled from Bloomberg L.P., the pretax yield on U.S. Treasury securities with a five-year maturity has declined from approximately 6.3% at December 31, 1999 to approximately 3.2% at July 31, 2003. An increase in interest rates could reduce the fair value of our investments in debt securities. As of August 29, 2003, the impact of an immediate 100 basis point increase in market interest rates on our debt securities portfolio would have resulted in an estimated decrease in fair value of 4.3% or approximately $58.8 million.

Our significant ownership interests in several closed-end preferred stock mutual funds may cause our net earnings to be more volatile than many other similar companies.

The equity method of accounting for our investment in any fund in which we own 20% or more requires us to recognize as a realized investment gain (loss) the change in the net asset value of the fund as compared to the end of our immediately preceding fiscal quarter. The closed-end preferred stock mutual funds that we account for using the equity method primarily invest in preferred stock. Therefore the decline in interest rates during the second quarter of 2003 caused a significant increase in the net asset value of those funds and, as a direct consequence, an increase in the net realized investment gains that we recognized for those investments for the six months ended June 30, 2003. If, as we expect, long-term interest rates are higher at September 30, 2003 than they were at June 30, 2003, the respective net asset values of those funds very likely would be less than they were at June 30, 2003, and we would recognize a net realized investment loss for the three months ending September 30, 2003 for any fund in which we owned 20% or more. Our ownership level in four of these funds currently remains above 20%. The impact of the equity method of accounting for our investment in those mutual funds has had and in the future may have a material adverse effect on our results of operations and may cause our results of operations to be more volatile than those of other similar companies.

For the six months ended June 30, 2003, our net earnings were materially affected by our realized investment gains, which increased $68.1 million after-taxes to $42.9 million after-taxes compared to a realized investment loss of $25.2 million after-taxes for the comparable period of 2002. The realized gains resulted primarily from improvements in the market values of underlying securities held by closed-end preferred stock mutual funds, which resulted in an increase in equity of $25.8 million and sales of securities of $24.3 million after-taxes. The increase in equity of closed-end preferred stock mutual funds resulted primarily from the decline in interest rates during the second quarter of 2003, which had the favorable effect of increasing the net asset value of seven closed-end preferred stock mutual funds in which we owned 20% or more and therefore were required to categorize as realized investment gains using the equity method of accounting.

As of the date of this prospectus, we still own four fund investments that we account for using the equity method. If, as we expect, long-term interest rates are higher at September 30, 2003 than they were at June 30, 2003, the respective net asset values of those funds as of September 30, 2003 very likely would be less than they were at June 30, 2003, and we would recognize a net realized investment loss for those four fund investments that may have a material adverse effect on our results of operations for the period ending September 30, 2003.

One or more adverse developments in a purported class action lawsuit pending against us could force us to increase materially our loss and loss adjustment expense reserves, which would adversely impact our results of operations.

A purported class action lawsuit is pending in Massachusetts state court against Commerce Insurance that alleges damages as a result of the purported inherent diminution in the value of vehicles that are involved in accidents. We have not established a reserve for any potential liability we may have in connection with this action because we are currently unable to estimate our potential exposure resulting from this lawsuit. However, if there were a final decision certifying that a relatively large class of our policyholders is entitled to recover damages based upon the inherent diminished value theory advocated by the plaintiff, we may have to increase materially our loss and loss adjustment expense reserves as a result, which would adversely impact our results of operations. Other insurance companies face similar suits in cases outside of Massachusetts.

In April 2002, the trial judge entered partial summary judgment for the plaintiff on the issue of whether the Massachusetts automobile policy covers her claim, ruling that the plaintiff would be entitled to reimbursement under the policy if the plaintiff were able both to prove that her vehicle suffered inherent diminished value in the accident and to quantify the amount of such diminution in value. Subsequently, the Massachusetts Division of Insurance issued an Advisory Ruling in which it stated, among other things, its position that the form of Massachusetts insurance policy at issue in the case does not cover claims for inherent diminished value. In addition, in a similar case brought against another Massachusetts insurer, a different Massachusetts trial judge ruled that claims for inherent diminution of value are not covered by the same Massachusetts automobile insurance policy.

The trial court in which the lawsuit against Commerce Insurance is pending has stayed all further proceedings, and the Massachusetts Supreme Judicial Court agreed to review this issue, heard oral argument on the case on March 4, 2003 and may render a decision at any time. If the Supreme Judicial Court determines that the Massachusetts automobile insurance policy at issue in the lawsuit pending against us covers a claim for inherent diminished value, then the Supreme Judicial Court will remand the case to the trial court, where we would vigorously oppose any potential effort by the plaintiff to certify a class.

Effective January 1, 2003, the form of automobile policy used by all insurers in Massachusetts was amended to confirm that there is no coverage for inherent diminished value as a result of any accident occurring after the effective date of the amendment.

We may not be able to successfully alleviate risk through reinsurance arrangements, which could cause us to reduce our premiums written in certain lines or could result in losses.

In order to reduce risk and to increase our underwriting capacity, we purchase reinsurance. The availability and the cost of reinsurance protection is subject to market conditions, which are outside of our control. A catastrophe, even if it primarily affects a geographic area outside of our markets, could significantly limit the availability of reinsurance, which would adversely affect our ability to obtain reinsurance. As a result, we may not be able to successfully alleviate risk through these arrangements. In addition, we are subject to credit risk with respect to our reinsurance because the ceding of risk to reinsurers does not relieve us of our liability to our policyholders. A significant reinsurer s insolvency or inability to make payments under the terms of a reinsurance treaty could have a material adverse effect on our results of operations and financial condition.

Our results may fluctuate due to the highly cyclical nature of the insurance industry.

Historically, the financial performance of the property and casualty insurance industry has tended to fluctuate in cyclical patterns of soft markets followed by hard markets. A hard market is an insurance market in which the demand for insurance exceeds the readily available supply and premiums are relatively high; conversely, a soft market is an insurance market in which the supply of insurance exceeds the current demand and premiums are relatively low. Although an individual insurance company s financial performance is dependent on its own specific business characteristics, the profitability of most property and casualty insurance companies tends to follow this cyclical market pattern. Since approximately the last half of 2001, the property and casualty insurance industry appears to be experiencing a hardening market. Because this cyclicality is due in large part to the actions of our competitors and general economic factors, we cannot predict with certainty how long this hardening market will last.

The failure of a key third party service vendor would adversely affect our ability to timely write Massachusetts automobile policies, which would adversely affect our results of operations.

We use a third party service vendor to provide rating and policy production data to us for use in underwriting our Massachusetts personal and commercial automobile policies. If this vendor were to suffer a catastrophic loss or otherwise be unable to provide us these data, we would be unable to write those policies until we obtained an alternative source for this information, which would adversely affect our results of operations and future customer relations.

We face risks from technology-related failures.

Increasingly, our businesses are dependent on computer and Internet-enabled technology. Although we have and test various disaster recovery plans, a sustained shutdown of one or more of our facilities, or a failure of one or more of our information technology, telecommunications or other business systems, could significantly impair our ability to perform our normal functions on a timely basis. In addition, because our information technology and telecommunications systems interface with and depend on third party systems, we could experience service denials if demand for such service exceeds capacity or third party systems fail or experience interruptions. If sustained or repeated, such a business interruption, systems failure or service denial could result in a deterioration of our ability to write and process new or renewal business, provide customer service, pay claims in a timely manner or perform other necessary corporate functions. This could materially and adversely affect our results of operations and future customer relations.

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Risks Related to the Notes

The notes may effectively be subordinated to any existing and future liability of ours or any of our subsidiaries.

You will effectively be subordinated to the debt and other liabilities of our subsidiaries, including their obligations to policyholders. We are a holding company and conduct nearly all our operations through our subsidiaries. Therefore, in the event of the insolvency or liquidation of a subsidiary, following payment by such subsidiary of its liabilities, including their obligations to policyholders, such subsidiary may not have sufficient remaining assets to make payments to us as a shareholder or otherwise. In the event of a default by a subsidiary under any credit arrangement or other indebtedness, its creditors could accelerate such debt, prior to such subsidiary distributing amounts to us that we could have used to make payments on the notes. In addition, if we caused a subsidiary to pay a dividend to us to make payment on the notes and such dividend were determined to be a fraudulent transfer, you would be required to return the payment to the subsidiary s creditors.

We and our subsidiaries will be able to issue or incur additional indebtedness that is senior to the notes in the future, provided the secured portion of such debt does not exceed 15% of our consolidated tangible net worth, as defined in the indenture for the notes.

We are a holding company, and we may not have access to the cash that is needed to make payment on the notes.

Nearly all of our operations are conducted through our subsidiaries, and none of our subsidiaries is obligated to make funds available to us for payment on the notes. Accordingly, our ability to make payments on the notes is dependent on the earnings and the distribution of funds to us from our subsidiaries. Restrictions on our subsidiaries ability to pay dividends or to make other cash payments to us may materially affect our ability to pay principal and interest on the notes and any other indebtedness.

Our subsidiaries are able to incur additional indebtedness that may restrict or prohibit the making of distributions, the payment of dividends or the making of loans by our subsidiaries to us. We cannot assure you that the agreements that may govern the future indebtedness of our subsidiaries will permit our subsidiaries to provide us with sufficient dividends, distributions or loans to fund payments on these notes when due.

Our insurance subsidiaries may declare and pay dividends to us only if they are permitted to do so under the insurance regulations of their respective domiciliary state. All of the states in which our insurance subsidiaries are incorporated regulate the payment of dividends. Under Massachusetts law, insurers may pay cash dividends only from earnings and statutory surplus, and the insurer s remaining surplus must be both reasonable in relation to its outstanding liabilities and adequate for its financial needs. Following the declaration and payment of such dividends, the insurer must file a report with the Commissioner. A Massachusetts insurance company may not pay an extraordinary dividend or distribution unless the insurer gives the Commissioner at least 30 days prior notice of the declaration and the Commissioner does not disapprove of the plan of payment prior to the date of such payment. An extraordinary dividend or distribution is one whose fair market value, together with that of other dividends or distributions within the preceding twelve-month period, excluding pro rata distributions of any class of the insurer s own securities, exceeds the greater of (1) ten percent of the insurer s surplus as regards to policyholders as of the preceding year end or (2) the net income of such insurer for the preceding year. California and Ohio have similar laws regulating the payment of dividends by insurance companies to those in Massachusetts.

The aggregate amount of dividends calculated in accordance with regulations of Massachusetts, California and Ohio that may be paid in 2003 from all of our insurance subsidiaries without prior regulatory approval is approximately $76.0 million, of which $66.2 million has been approved and paid as of June 30, 2003.

Notwithstanding the foregoing, if insurance regulators otherwise determine that payment of a dividend or any other payment to an affiliate would be detrimental to an insurance subsidiary s policyholders or creditors, because of the financial condition of the insurance subsidiary or otherwise, the regulators may block dividends or other payments to affiliates that would otherwise be permitted without prior approval.

The notes comprise a new issue of securities for which there is currently no public market.

The notes will not be listed on any securities exchange or included in any automated quotation system. We do not know whether an active trading market will develop for the notes. If the notes are traded after their initial issuance, they may trade at a discount from their initial offering price depending on prevailing interest rates, the market for similar securities, our performance and other factors. We do not intend to apply for listing of the notes on any securities exchange or other stock market.

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus and the documents it incorporates by reference may contain statements that are not historical fact and constitute forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act. Statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. These statements are often, but not always, made through the use of words or phrases such as anticipates, estimates, plans, projects, continuing, ongoing, expects, may, should, management believes, we believe, we intend and similar words or phrases. ' may address, among other things, our strategy for growth, business development, regulatory approvals, market position, expenditures, financial results and reserves. Accordingly, these statements involve estimates, assumptions and uncertainties that could cause actual results to differ materially from those expressed in them. All forward-looking statements are qualified in their entirety by reference to the factors discussed throughout this prospectus and in the documents incorporated by reference. Among the key factors that could cause actual results to differ materially from the forward-looking statements:

- the possibility of severe weather and adverse catastrophe experiences,
- adverse trends in claim severity or frequency,
- adverse state and federal regulation and legislation,
- adverse judicial decisions,
- interest rate risk,
- rate making decisions for private passenger automobile policies in Massachusetts,
- potential rate filings outside of Massachusetts,
- heightened competition,
- concentration of business within Massachusetts,
- dependence on our executive officers, and
- the economic, market or regulatory conditions and risks associated with entry into new markets and diversification.

These important factors are discussed in more detail in this prospectus under Risk Factors and under Our Business and Management s Discussion and Analysis of Financial Condition and Results of Operations and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2002, our Quarterly Reports on Form 10-Q for the three-month period ended March 31, 2003 and the three- and six-month periods ended June 30, 2003, and other documents we have filed with the SEC and which are incorporated by reference herein. You may obtain copies of these documents as described under Where You Can Find More Information; Incorporation by Reference.

You should not place undue reliance on any forward-looking statement. The risk factors referred to above, as well as the risk factors in this prospectus, could cause actual results or outcomes to differ materially

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from those expressed in any forward-looking statement made by us or on our behalf. Further, any forward-looking statement speaks only as of the date on which it is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for us to predict which factors will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

SOURCES OF CERTAIN STATISTICAL AND OTHER INFORMATION

This prospectus includes or incorporates by reference certain statistical and other data with respect to us, our products and services and our industry, derived from publicly available reports and other publications of A.M. Best and Bloomberg L.P. referenced in this prospectus. These organizations generally use methodology and conventions that they deem appropriate to measure companies within the relevant industry segment. These organizations generally indicate that they have obtained information from sources believed to be reliable, but do not guarantee the accuracy and completeness of such information. While we believe this information to be reliable, we have not independently verified such data.

ABOUT COMMERCE GROUP

The Commerce Group, Inc., a Massachusetts corporation, is an insurance holding company that was incorporated in 1976. We currently operate four property and casualty insurance subsidiaries:

The Commerce Insurance Company;

Citation Insurance Company;

American Commerce Insurance Company; and

Commerce West Insurance Company.

Commerce Insurance, our principal operating subsidiary, is located in Webster, Massachusetts and was founded in 1971. Commerce Insurance and Citation, also located in Webster, Massachusetts, write primarily personal and commercial automobile and homeowners insurance in Massachusetts and, to a much lesser extent, in New Hampshire. Commerce Insurance and Citation are wholly owned subsidiaries of Commerce Holdings, Inc., which is a wholly-owned subsidiary of Commerce Group.

American Commerce, located in Columbus, Ohio, writes primarily personal automobile and homeowners insurance in 26 states. American Commerce is a wholly-owned subsidiary of ACIC Holding Co., Inc., which acquired American Commerce in 1999. Prior to that acquisition, American Commerce was known as Automobile Club Insurance Company and was a subsidiary of the American Automobile Association. Commerce Insurance owns a 95% equity interest in ACIC Holding. The other 5% is owned by AAA Southern New England. Since 1995, we have maintained an affinity group marketing relationship with AAA Insurance Agency, Inc., a subsidiary of AAA Southern New England. AAA Insurance Agency, Inc. has been a licensed insurance agent of ours since 1985.

Commerce West, a wholly-owned subsidiary of Commerce Insurance located in Pleasanton, California, writes primarily personal and commercial automobile insurance in California and Oregon. Prior to our acquisition of Commerce West in 1995, it was known as Western Pioneer Insurance Company.

Commerce Group also owns Bay Finance Company, Inc., which originates and services residential and commercial mortgages primarily in Massachusetts, and Clark-Prout Insurance Agency, which offers a full line of insurance products, including policies written by us.

The following shows our current organizational structure:

We are considering an internal reorganization that would result in each of ACIC Holding and Commerce West becoming direct subsidiaries of Commerce Holdings, rather than Commerce Insurance. The reorganization may occur after the offering of the notes. The purpose of the reorganization would be to allow us to use capital more efficiently through our operating subsidiaries and to streamline our organizational structure. Massachusetts insurance regulations would require us to contribute cash to the operating subsidiaries in order to effect the reorganization. We do not expect the reorganization to have a material effect

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on how we operate our business. The following is our expected organizational structure following the reorganization:

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USE OF PROCEEDS

We estimate that we will receive net proceeds from the offering of the notes of approximately $ million, based on an assumed public offering price of $ per note. We intend to use the net proceeds from the offering for general corporate purposes, including to enhance the capital position of our insurance operating subsidiaries in support of recent premium growth, as well as to continue diversification efforts outside of Massachusetts by our existing subsidiaries. The enhancement of the capital position will be accomplished, in part, through the completion of the internal reorganization described under About Commerce Group. Until we use the net proceeds in the manner described in this section, we may temporarily use them to make short-term investments.

We expect that a substantial portion of the proceeds will be invested in one or more of our insurance company subsidiaries, will be added to the investment portfolios of those subsidiaries, and may be used, in whole or in part, to support premium growth. We anticipate such proceeds will be invested in securities that are consistent with our investment guidelines and policies. Discussions of the nature of such securities holdings are set forth under Our Business Investments.

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CAPITALIZATION

The table below shows our unaudited consolidated capitalization as of June 30, 2003. The table also shows adjustments to our capitalization to reflect this offering. You should read this table in conjunction with our consolidated financial statements, the related notes and other financial information included in this prospectus.

	As of June 30, 2003	
	Actual	As adjusted
	(Dollars in thousands)	
Debt:		
% Senior Notes due	$	
Total debt	$	
Minority Interest	$ 4,228	
Stockholders equity:		
Preferred stock, authorized 5,000,000 shares at $1.00 par value; none issued		
Common stock, authorized 100,000,000 shares at $.50 par value; 38,356,822 shares issued, including 6,401,792 treasury shares	19,178	
Paid-in capital	42,140	
Net accumulated other comprehensive income, net of income taxes of $17,421.	32,353	
Retained earnings	941,544	
Treasury stock, at cost	(179,289)	
Total stockholders equity	855,926	
Total debt, minority interest and stockholders equity	$ 860,154	

RATIO OF EARNINGS TO FIXED CHARGES

The following table presents our ratio of earnings to fixed charges on a consolidated basis for the periods shown:

Six Months Ended June 30, 2003	Year Ended December 31, 2002	2001	2000	1999	1998
2,400.1x	554.5x	1,135.5x	1,829.7x	1,272.8x	2,230.4x

We have computed the ratio of earnings to fixed charges by dividing earnings before income taxes plus fixed charges by fixed charges. Fixed charges consist of the portion of rents representative of the interest factor.

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SELECTED FINANCIAL AND OPERATING DATA

The data below should be read in conjunction with our consolidated financial statements, related footnotes, and other financial information included in this prospectus. The financial statements for the five years ended December 31, 2002 have been audited by Ernst & Young LLP. The data presented below as of and for the six months ended June 30, 2003 and for the six months ended June 30, 2002 are derived from our unaudited condensed consolidated financial statements for such periods appearing elsewhere in this prospectus. Such unaudited condensed consolidated financial statements have been prepared on the same basis as our audited consolidated financial statements and, in our opinion, include all adjustments, which consist only of normal recurring adjustments, necessary for a fair presentation of our financial condition and results of operations. Operating results for the six month period ended June 30, 2003 are not necessarily indicative of the results that may be expected for the entire year ending December 31, 2003.

	Six Months Ended June 30,		Year Ended December 31,				
	2003	2002	2002	2001	2000	1999	1998
	(Dollars in thousands, except per share data)						
	(Unaudited)						
		(Restated)		(Restated)			
Statement of Earnings Data:							
Net premiums written	$ 812,510	$ 702,037	$ 1,313,014	$ 1,078,967	$ 1,008,911	$ 911,993	$ 745,048
(Increase) decrease in unearned premiums	(124,254)	(124,863)	(102,974)	(35,315)	(54,428)	(40,163)	572
Earned premiums	688,256	577,174	1,210,040	1,043,652	954,483	871,830	745,620
Net investment income	45,812	47,762	98,466	99,563	96,830	89,789	86,501
Premium finance and service fees	13,245	9,997	21,498	17,819	15,227	14,774	13,440
Amortization of excess of book value of subsidiary interest over cost				3,389	3,390	3,019	
Net realized investment gains (losses)	60,020	(34,992)	(82,385)	(10,633)	29,550	(16,378)	7,150
Other income		7,000	9,500				
Total revenues	807,333	606,941	1,257,119	1,153,790	1,099,480	963,034	852,711
Losses and loss adjustment expenses	543,605	439,551	909,769	781,631	686,157	625,090	531,429
Policy acquisition costs	155,770	142,072	295,324	264,377	243,257	233,660	196,434
Total expenses	699,375	581,623	1,205,093	1,046,008	929,414	858,750	727,863
Earnings before income taxes, minority interest and change in accounting principle	107,958	25,318	52,026	107,782	170,066	104,284	124,848
Income taxes	23,485	4,048	17,063	18,392	38,306	16,667	26,583
Net earnings before minority interest and change in accounting principle	84,473	21,270	34,963	89,390	131,760	87,617	98,265
Minority interest in net (earnings) loss of subsidiary	(80)	163	555	863	320	1,059	
Net earnings before change in accounting principle	84,393	21,433	35,518	90,253	132,080	88,676	98,265

Change in accounting principle net of taxes		11,237	11,237				
Net earnings	$ 84,393	$ 32,670	$ 46,755	$ 90,253	$ 132,080	$ 88,676	$ 98,265
Comprehensive income	$ 91,482	$ 46,336	$ 59,625	$ 90,814	$ 168,570	$ 40,730	$ 96,594
Net earnings per common share before cumulative effects of change in accounting principle:							
Basic	$ 2.64	$ 0.65	$ 1.08	$ 2.69	$ 3.87	$ 2.54	$ 2.73
Diluted	$ 2.62	$ 0.64	$ 1.08	$ 2.67	$ 3.87	$ 2.54	$ 2.73
Net earnings per common share from the cumulative effects of change in accounting principle:							
Basic	$	$ 0.34	$ 0.34	$	$	$	$
Diluted	$	$ 0.34	$ 0.34	$	$	$	$

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SELECTED FINANCIAL AND OPERATING DATA (Continued)

	Six Months Ended June 30,		Year Ended December 31,				
	2003	2002	2002	2001	2000	1999	1998
	(Dollars in thousands, except per share data)						
	(Unaudited)	(Restated)		(Restated)			
Statement of Earnings Data:							
Net earnings per common share:							
Basic	$ 2.64	$ 0.99	$ 1.43	$ 2.69	$ 3.87	$ 2.54	$ 2.73
Diluted	$ 2.62	$ 0.98	$ 1.42	$ 2.67	$ 3.87	$ 2.54	$ 2.73
Cash dividends paid per share	$ 0.63	$ 0.61	$ 1.23	$ 1.19	$ 1.15	$ 1.11	$ 1.07
Weighted average number of shares outstanding:							
Basic	31,986,847	33,025,426	32,773,519	33,608,804	34,121,047	34,940,074	36,042,652
Diluted	32,187,013	33,355,669	33,028,081	33,794,938	34,121,047	34,940,074	36,042,652

	At June 30, 2003	At December 31, 2002	2001	2000	1999	1998
	(Unaudited)		(Restated)			
	(Dollars in thousands, except per share data)					
Balance Sheet Data:						
Total investments	$1,751,649	$1,577,070	$1,498,201	$1,472,562	$1,295,995	$1,262,500
Premiums receivable	392,743	297,610	246,221	230,580	195,160	162,878
Total assets	2,729,382	2,382,688	2,154,631	2,075,614	1,878,019	1,747,583
Unpaid losses and loss adjustment expenses	893,248	815,626	695,192	674,140	659,841	583,996
Unearned premiums	822,727	687,148	563,456	519,885	457,095	391,424
Stockholders equity	855,926	790,052	809,433	781,881	668,005	710,852
Stockholders equity per share	$ 26.79	$ 24.60	$ 24.43	$ 23.16	$ 19.44	$ 19.72

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MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

Overview

We provide personal and commercial property and casualty insurance in Massachusetts and, to a lesser extent, in 27 other states. Casualty insurance is primarily concerned with the losses of the insured due to injuries to other persons and to the property of others, and the legal liability imposed on the insured as a consequence of such losses. Our core product lines are personal automobile, homeowners, and commercial automobile insurance. We market our products almost exclusively through our network of independent agents, including 628 agents in Massachusetts, 30 agents in New Hampshire, 808 agents in California and Oregon, and 32 agents in 26 other states. We have been the largest writer of personal property and casualty insurance in Massachusetts in terms of direct premiums written since 1990, and for each of the past five years, we have been the second largest writer of homeowners insurance in Massachusetts. Our primary business strategy is to continue to focus on the personal automobile insurance market in Massachusetts and to enhance our geographic diversity by increasing the proportion of our business in other states in which we currently do business, primarily as a result of our acquisitions of Commerce West and American Commerce in 1995 and 1999, respectively.

The property and casualty insurance industry is highly competitive and inherently volatile in nature. Property and casualty insurance company results have traditionally been affected by the typical forces in the industry, such as competition, frequency and severity of losses, the overall economy and the general regulatory environment in those states in which the insurer operates. Deregulation, changes in theories of liability, on-line commerce, price competition, empowered customers and technological advancement also affect the industry. Price competition remains quite heavy in many areas of the country, although it improved in 2002 among independent agency companies in Massachusetts.

Our revenue principally reflects:

- earned premiums, consisting of
  - premiums that we receive from sales by our agents of property and casualty insurance policies, primarily personal automobile, homeowners and commercial automobile, which we refer to in this prospectus as direct premiums written, *plus*
  - premiums we receive from insurance policies that we assume, primarily from CAR, which we refer to in this prospectus as assumed premiums, *less*
  - the portion of our premiums that is ceded to CAR and other reinsurers, which we refer to in this prospectus as ceded premiums, *less*
  - the change in the portion of premiums that will not be recognized as income for accounting purposes until a future period, which we refer to in this prospectus as unearned premiums;
- investment income that we earn on our invested assets;
- premium finance charges and service fee income that we earn in connection with the billing and deferral of premium payments; and
- realized investment gains (losses).

Our expenses principally reflect:

- incurred losses and loss adjustment expenses (which we sometimes refer to in this prospectus as LAE), including estimates for losses incurred during the period but not yet reported to us and changes in estimates from prior periods related to direct and assumed business, *less* the portion of those incurred losses and loss adjustment expenses that are ceded to other insurers; and
- policy acquisition costs, including agent compensation and general and administrative costs, such as salaries and benefits, and advertising that are not deferred for accounting purposes to a future period.

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Measurement of Results

We evaluate our operations by monitoring key measures of growth and profitability. We measure our growth by examining our direct premiums written. We generally measure our operating results by examining our net income, return on equity, and our loss, expense and combined ratios. The following provides further explanation of the key measures that we use to evaluate our results:

Direct Premiums Written. Direct premiums written is the sum of the total policy premiums, net of cancellations, associated with policies underwritten and issued by our insurance subsidiaries. We use direct premiums written, which includes premiums that we cede to CAR and other reinsurers, as a measure of the underlying growth of our insurance business from period to period.

Net Premiums Written. Net premiums written is the sum of direct premiums written for a given period, less premiums ceded to CAR and other reinsurers during such period, plus premiums assumed during such period.

Earned Premiums. Earned premiums constitutes the portion of net premiums written that is equal to the expired portion of policies and recognized as income for accounting purposes during a given period.

Investment Income. Investment income relates to the money earned on our investment portfolio. We rely on after-tax investment income as a significant source of net earnings since we generally seek to produce a combined ratio of slightly less than 100%.

Loss Ratio. Loss ratio is the ratio of losses and loss adjustment expenses incurred to premiums earned, expressed as a percentage, and measures the underwriting profitability of a company s insurance business. Our loss ratio is measured net of reinsurance recoveries. We use the loss ratio as a measure of the overall underwriting profitability of the insurance business we write and to assess the adequacy of our pricing. Our loss ratios are generally calculated using statutory accounting principles which for this purpose are essentially the same as accounting principles generally accepted in the United States (GAAP). Occasionally in this prospectus we will use the term pure loss ratio which refers to the ratio (expressed as a percentage) of incurred losses net of reinsurance recoveries but excluding LAE, to earned premiums.

Underwriting Expense Ratio. The underwriting expense ratio is the ratio of underwriting expenses to net premiums written, expressed as a percentage, determined in accordance with statutory accounting principles. Underwriting expenses are the aggregate of policy acquisition costs, including commissions, and the portion of administrative, general and other expenses attributable to underwriting operations.

Combined Ratio. Combined ratio is the sum of the loss ratio and the underwriting expense ratio and measures a company s overall underwriting profit. If the combined ratio is at or above 100%, an insurance company cannot be profitable without investment income, and may not be profitable if investment income is insufficient. We use the statutory combined ratio in evaluating our overall underwriting profitability and as a measure for comparison of our profitability relative to the profitability of our competitors.

Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires our management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. We consider the following accounting policies, which are derived based on management s judgments and estimates, to be critical to the preparation of our financial statements.

Unpaid Losses and Loss Adjustment Expenses. Unpaid losses and LAE, by their nature, are inherently uncertain as to the ultimate outcome of the estimated amounts. The liability for unpaid losses and LAE represents our best estimate of the ultimate net cost of all losses and LAE incurred through the balance sheet date. The estimate for ultimate net cost of all losses incurred through the balance sheet date includes the adjusted case estimates for losses, incurred but not reported (IBNR) losses, salvage and subrogation recoverable and a reserve for LAE. In arriving at our best estimate, we begin with the aggregate of individual case reserves and then make adjustments to these amounts on a line of business basis. These adjustments to the aggregate case reserves by line of business are made based on analyses performed by us as further described below. The entire liability for unpaid losses and LAE is also separately reviewed quarterly and annually by our Actuarial Department. Liability estimates are continually analyzed and updated, and therefore, the ultimate liability may be more or less than the current estimate. The effects of changes in the estimates are included in the results of operations in the period in which the estimates are revised.

The claim cycle begins when a claim is reported to us and claims personnel establish a case reserve for the estimated amount of our exposure without regard to injury causality, third party liability or potential recoveries. The amount of the reserve is primarily based upon an evaluation of the type of claim involved, the circumstances surrounding the claim and the policy provisions relating to the loss. This estimate reflects the informed judgment of such personnel based on the experience and knowledge of the claims personnel adjusting the claim. During the loss adjustment period, these case basis estimates are revised as deemed necessary by our claims department personnel based on subsequent developments and periodic reviews of the claim.

In accordance with industry practice, we also maintain reserves for estimated IBNR, salvage and subrogation recoverable and LAE. These reserves are determined based on historical information and our experience. Adjustments to these reserves are made periodically to take into account changes in the volume of policies written, claims frequency, severity and payment patterns, the mix of business, claims processing and other items that can be expected to affect our liability for losses and LAE over time.

When reviewing the liability for unpaid losses and LAE, we analyze historical data and estimate the impact of various factors such as:

- payment trends;
- loss expense per exposure;
- our historical loss experience and that of the industry;
- frequency and severity trends; and
- legislative enactments, judicial decisions, legal developments in the imposition of damages, and changes and trends in general economic conditions, including the effects of inflation and recession.

This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. There is no precise method, however, for subsequently evaluating the impact of any specific factor on the adequacy of reserves, because the eventual development of reserves is affected by many factors, as noted above.

By using individual estimates of reported claims adjusted for our best estimate by line of business and a review of these results by our actuarial area using generally accepted actuarial reserving techniques, we estimate the ultimate net liability for losses and LAE. After taking into account all relevant factors, we believe that, based on existing information, the provision for losses and LAE at June 30, 2003 is adequate to cover the ultimate net cost of losses and claims incurred as of that date. The ultimate liability, however, may be greater or lower than established reserves. If the ultimate payment is greater than or less than our estimated liability for losses and LAE, based on any of the factors noted previously, we will incur additional expense or income, as appropriate, which may have a material impact on our results of operations.

At December 31, 2002, for all of our insurance subsidiaries, the aggregate actuarial estimate for the loss and LAE reserves, prior to the effect of ceded reinsurance recoverable, ranged from a low of $607.3 million to a high of $700.6 million. Our financial statement loss and LAE reserves, based on our best estimate, was established at $678.3 million as of December 31, 2002. We calculate our estimate separately from those amounts as calculated by our actuaries and, therefore, the final results are most often not the same. We estimate our amounts primarily by reviewing historical loss and LAE data, focusing mainly on payment data. We also review and compare the most recent loss frequency, severity, and payment data to historical trends in

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an attempt to determine if patterns are remaining consistent or not. We attempt to establish our reserve estimate as close to the amount required for the ultimate future payments necessary to settle all losses.

Investments. A focus of our judgments and estimates relating to investments involves the potential impairment of investments for other-than-temporary declines in market values. The carrying value of investments in fixed maturities, which include taxable and non-taxable bonds, and investments in common and preferred stocks, are derived from market prices supplied by our investment custodian. Unrealized investment gains and losses on common and preferred stocks and fixed maturities, to the extent that there is no other-than-temporary impairment of value, are credited or charged, net of any tax effect, to a separate component of stockholders equity, known as net accumulated other comprehensive income (loss), until realized. We review all security holdings on a quarterly basis with regards to other-than-temporary declines in market value pursuant to Statement of Financial Accounting Standards (SFAS) No. 115 (Accounting for Certain Investments in Debt and Equity Securities) and other applicable guidance. As part of this process, we consider any significant market declines in the context of the overall market and also in relation to the outlook for the specific issuer of the security. From a quantitative standpoint, we view all securities that have declined more than 20% below book price and have remained so for two quarters as potentially in need of a writedown. In addition, any other security that we view as impaired for a significant period of time is also a candidate for a writedown, even if the percentage decline is less than 20%.

Due to our significant ownership interests in several closed-end preferred stock mutual funds, we are required when accounting for those investments to use the equity method of accounting, which has significantly affected our net income in recent periods. The equity method of accounting for our investment in any fund in which we own 20% or more requires us to categorize as a realized investment gain or loss the change in the net asset value of that fund as compared to the end of the immediately preceding fiscal quarter. As of the date of this prospectus, we have investments in four funds that meet this criteria. Each of those funds primarily invests in preferred stock, and therefore the decline in interest rates during the second quarter of 2003 caused a significant increase in the net asset value of those funds and, as a direct consequence, an increase in the net realized investment gains that we recognized for those investments for the six months ended June 30, 2003. However, if, for example, interest rates are higher at September 30, 2003 than they were at June 30, 2003, the respective net asset values of those funds would likely be less than they were as of June 30, 2003, and we would recognize a net realized investment loss for the three months ended September 30, 2003 for any fund in which we owned 20% or more. The impact of the equity method of accounting for our investment in those mutual funds has had and in the future may have a material adverse effect on our results of operations and may cause our results of operations to be more volatile than those of similar companies.

Massachusetts Personal Automobile Insurance

Overview. We remain focused on personal automobile insurance and related activities in Massachusetts. We have been the largest writer of personal property and casualty insurance in Massachusetts in terms of market share of direct premiums written since 1990. Our share of the Massachusetts personal automobile market increased to 27.3% during the six months ended June 30, 2003, as shown in the table below, significantly exceeding our two nearest competitors, who maintained a 10.8% and 10.2% market share, respectively.

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Growth of Massachusetts Personal Automobile Insured Vehicles

	Industry*	Commerce	Commerce Period-End Market Share
Six Months Ended June 30, 2003	<1%	6.1%	27.3%*
Year Ended December 31, 2002	1.8	13.9	25.9
Year Ended December 31, 2001	1.7	6.1	23.2
Year Ended December 31, 2000	1.9	6.5	22.3

* Estimated by CAR

In Massachusetts, private passenger automobile insurance is subject to extensive regulation. Owners of automobiles are generally required to demonstrate certain minimum automobile insurance coverages as a prerequisite to registering any automobile. With very limited exceptions, private passenger automobile insurers are required by law to issue a policy to any applicant seeking to obtain such coverages, commonly known as the take all comers law. On the basis of their market shares, insurers in Massachusetts are also assigned agents, known as ERPs, that have been unable to obtain a voluntary contract with an insurance carrier. Marketing and underwriting strategies for companies operating in Massachusetts are limited by maximum premium rates and minimum agency commission levels for personal automobile insurance, both of which are mandated by the Commissioner. In Massachusetts, accident rates, bodily injury claims, and medical care costs continue to be among the highest in the nation. According to the Automobile Insurers Bureau of Massachusetts, or AIB, Massachusetts has higher than average medical costs and liability claims involving attorneys. According to the AIB, Massachusetts personal automobile premium per policy, based on 2001 premium information, was the 5th highest in the nation.

Changes in Premium Rates. During the three-year period from 2000 to 2002, average mandated Massachusetts personal automobile insurance premium rates decreased an average of 2.5% per year. The Commissioner approved an average increase of 2.7% in personal automobile premiums for 2003, as compared to no rate change in 2002. Coinciding with the 2003 rate decision, the Commissioner also approved an increase of 1.3 percentage points to the commission agents receive for selling private passenger automobile insurance for 2003. The following table shows the state-mandated average rate change, the actual average rate change and our average rate change per exposure as estimated for 2003 and for the three previous years in Massachusetts.

Year	State Mandated Average Rate Change(2)	Actual State Average Rate Change(2)	Commerce Average Rate Change Per Exposure
2003(1)	2.7%	8.1%	8.0%
2002	0.0	5.0	5.3
2001	(8.3)	(3.5)	(1.9)
2000	0.7	6.2	6.2

(1) Estimated

(2) Based on Massachusetts Division of Insurance Filings

Although mandated average personal automobile premium rates were unchanged in 2002, our average rate increased 5.3% per exposure. We believe that the relative increase for 2002 as compared to the Commissioner s state mandated average rate resulted primarily from several factors:

- a decrease in our Safe Driver Insurance Plan deviation for the best driver classification in Massachusetts;

- the fact that our mix of personal automobile coverage differs from that of the industry; and

- changes to our distribution of risks by class, territory and coverage, including changes resulting from the purchase of new, more expensive automobiles, which were not factored into the Commissioner s rate increase.

The actual state average rate change represents the change in the average rate paid by drivers in Massachusetts, as opposed to the state mandated average rate change. As can be seen above, our average rate change per exposure corresponds more closely to the actual state average rate change. The reason for this is that both take into account newer vehicles, as compared to the state mandated average rate change, which does not.

CAR. Our performance in our personal and commercial automobile insurance lines in Massachusetts is integrally tied to our participation in Commonwealth Automobile Reinsurers, known as CAR, the state-mandated reinsurance mechanism. CAR permits us and most other writers of automobile insurance in Massachusetts to reinsure any automobile risk that the insurer perceives to be under-priced at the premium level permitted by the Commissioner. All companies writing automobile insurance in Massachusetts share in the underwriting results of CAR business for their respective product line or lines. Since CAR s inception, it has annually generated hundreds of millions of dollars of underwriting losses, primarily in the personal pool. We are required to share in CAR s underwriting results for our respective product lines. Under current regulations, our share of the CAR personal or commercial deficit is based upon our market share for retained automobile risks for the particular pool, adjusted by a utilization concept, such that, in general, we are disproportionately and adversely affected if our relative use of CAR reinsurance exceeds that of the industry, and favorably affected if our relative use of CAR reinsurance is less than that of the industry. For personal automobile insurance, insurers can reduce their participation ratio by voluntarily writing credit eligible business. Companies are provided credits against their participation ratio for writing those policies that are intentionally underpriced by the Commissioner in the rate setting process. Our strategy has been to maintain above average voluntary retention levels, as well as to voluntarily retain private passenger automobile risks that receive credits. This favorably impacts our participation ratio compared to our market share, but also adversely impacts our voluntary loss ratio. We reinsured through CAR approximately 4.8%, 4.9%, 4.9% and 4.9% of our personal automobile exposures for the six months ended June 30, 2003 and the years ended December 31, 2002, 2001 and 2000, as compared to industry averages of 6.9%, 7.5%, 7.7% and 8.4% for the same periods, respectively. See Our Business Commonwealth Automobile Reinsurers.

Affinity Group Marketing. Since 1995, we have been a leader in affinity group marketing in Massachusetts, through agreements with the four American Automobile Association Clubs operating in Massachusetts, offering discounts on private passenger automobile insurance to the clubs members who reside in Massachusetts. A 5% discount was approved by the Commissioner for policies effective January 1, 2003. Based on information provided to us by the AAA clubs operating in Massachusetts, we believe that membership in these clubs represents approximately one-third of the Massachusetts motoring public, and has been the primary reason for an 85.2% increase in the number of personal automobile exposures written by us since year-end 1995. The following table presents total direct premiums written attributable to the AAA clubs group business in Massachusetts for the periods indicated:

	For the Six Months Ended June 30,		For the Year Ended December 31,		
	2003	**2002**	**2002**	**2001**	**2000**
			(Dollars in thousands)		
Total AAA-Massachusetts direct premiums written	$375,800	$336,200	$619,000	$545,500	$535,800
Percentage of total direct premiums written	43.5%	45.9%	44.0%	47.3%	50.0%
Percentage of Massachusetts direct personal automobile premiums	58.7%	60.2%	60.0%	63.4%	64.8%
Total AAA-Massachusetts exposures	358,900	346,200	625,000	581,500	559,700
Percentage of Massachusetts exposures	58.8%	60.2%	59.8%	63.3%	64.5%

The decreasing percentages from 2000 are attributable to a higher rate of increase in non-group business as compared to increases in the AAA program. Of the total Massachusetts automobile exposures written through the AAA affinity group program by us, approximately 13.5% were written through insurance agencies owned by the AAA clubs (8.5% of our total Massachusetts automobile exposures). The remaining 86.5% of

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the AAA group program were written through our network of independent agents (91.5% of our total Massachusetts automobile exposures).

Other States

Direct premiums written in states other than Massachusetts by American Commerce and Commerce West increased $26.7 million, or 30.9%, to $112.9 million at June 30, 2003 from $86.2 million at June 30, 2002. American Commerce direct premiums written increased $21.7 million or 33.6%, primarily due to an increase in personal automobile premiums of $17.9 million, or 34.5%. American Commerce also experienced a 30.3% increase in homeowners premiums written, primarily attributable to book transfers in various states, increased retention on existing business, additional rate per policy and the contraction of authority to write homeowner business by competitors. Commerce West premiums written increased $5.0 million, or 23.0%. The growth for Commerce West is primarily attributable to expansion of commercial and preferred personal automobile programs. Personal automobile direct premiums written by Commerce West increased $2.8 million, or 14.4%, while commercial automobile direct premiums written increased $2.2 million, or 108.3%.

Direct premiums written in states other than Massachusetts by American Commerce and Commerce West increased $42.2 million, or 29.5%, to $185.5 million for the year ended December 31, 2002 from $143.3 million for the year ended December 31, 2001. American Commerce direct premiums written for the year ended December 31, 2002 increased $34.7 million or 33.2%, primarily due to an increase in personal automobile premiums of $26.6 million, or 31.3%. American Commerce also experienced a 46.3% increase in homeowners premiums written, primarily as a result of book transfers from existing agents and the contraction of authority to write homeowner business by competitors. Commerce West direct premiums written for the year ended December 31, 2002 increased $7.5 million, or 19.5%. The growth from Commerce West is primarily attributable to expansion of the commercial and preferred personal automobile programs. Personal automobile direct premiums written by Commerce West for the year ended December 31, 2002 increased $3.9 million, or 10.5%, while commercial automobile direct premiums written for the year ended December 31, 2002 increased $3.6 million, or 240.2%. For a presentation of direct premiums written by state for American Commerce and Commerce West for the six months ended June 30, 2003 and the years ended December 31, 2002 and 2001, see Our Business Overview Business in Other States.

2001 Restatement for Employee Stock Option Variable Accounting Treatment

For employee stock options which we issued from 1999 through 2001, we used fixed accounting treatment through September 30, 2002. This accounting treatment was reviewed with our independent auditors at that time, Ernst & Young LLP, who concurred with our treatment throughout this period. In January 2003, a question was raised by Ernst & Young LLP as to the appropriateness of the fixed accounting treatment for some of our option grants. Ernst & Young LLP advised us that it could no longer concur with the use of fixed accounting for the options granted to employees in 1999 and 2000. Therefore, we applied variable accounting treatment in 2002, as well as retroactively to 2001 and prior years. Accordingly, we restated results for 2001 and the first three quarters of 2002. The impact of the restatement for the year ended 2001 resulted in a decrease in net earnings of $2.8 million, or $0.08 per diluted share. Although the change in accounting for employee options was also applied to 2000 and 1999, no restatements were required for those years. The impact of variable accounting for the year ended December 31, 2002 was a decrease to net earnings of $2.1 million, or $0.07 per diluted share. As allowed by SFAS No. 148, we have elected to continue to apply variable accounting for our stock options granted in 1999 and 2000. We continue to comply with APB Opinion No. 25 and related interpretations in applying fixed accounting for the employee stock options granted in 2001.

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Six Months Ended June 30, 2003 Compared to Six Months Ended June 30, 2002 (Restated)

Overview

Our net earnings for the six months ended June 30, 2003 were favorably affected primarily by significant increases in our realized investment gains and earned premiums, which more than offset an unfavorable development in our loss ratio.

Our after-tax net realized investment gains for the six months ended June 30, 2003 increased by $68.1 million compared to the same period of 2002. The increase resulted primarily from:

- our decision to sell during the period a significant portion of our securities with unrealized gains in order to implement a change in our investment strategy to shorten the overall duration of our investment portfolio; and

- the favorable impact of the decline in interest rates during the second quarter on the net asset value of seven closed-end preferred stock mutual funds that we, at the time, had to categorize as realized investment gains using the equity method of accounting.

See Investment Gains and Losses.

Our earned premiums increased by $111.1 million, or 19.2%, for the six months ended June 30, 2003 compared to same period of 2002. The increase resulted primarily from an increase of $75.0 million, or 18.0%, in earned premiums for personal automobile coverage in Massachusetts and an increase of $20.8 million, or 30.6%, in earned premiums for personal automobile coverage outside of Massachusetts. See Premiums.

Our losses and loss adjustment expenses increased by $104.1 million, or 23.7%, for the six months ended June 30, 2003 compared to the same period of 2002. The increase resulted primarily from our premium growth and an increase in our loss ratio (on a statutory basis) to 78.7% for the six months ended June 30, 2003 compared to 75.8% for the same period of 2002. The increase in our loss ratio resulted primarily from severe winter weather during the first quarter of 2003 in our Massachusetts market. See Loss and Loss Adjustment Expenses.

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Premiums

The following table compares direct premiums written, net premiums written and earned premiums for the six months ended June 30, 2003 and 2002.

	Six Months Ended June 30,			
	2003	2002	$ Change	% Change
	(Dollars in thousands)			
Direct Premiums Written:				
Personal automobile in Massachusetts	$639,819	$558,310	$ 81,509	14.6%
Personal automobile in all other states	94,411	71,346	23,065	32.3
Commercial automobile in Massachusetts	46,945	38,801	8,144	21.0
Commercial automobile in all other states	4,149	1,992	2,157	108.3
Homeowners in Massachusetts	44,787	35,868	8,919	24.9
Homeowners in all other states	16,876	12,540	4,336	34.6
Other lines in Massachusetts	17,139	12,724	4,415	34.7
Other lines in all other states	455	348	107	30.7
Total direct premiums written	$864,581	$731,929	$132,652	18.1
Net Premiums Written:				
Personal automobile in Massachusetts	$641,997	$569,058	$ 72,939	12.8%
Personal automobile in all other states	94,382	71,314	23,068	32.3
Commercial automobile in Massachusetts	50,041	42,787	7,254	17.0
Commercial automobile in all other states	3,982	1,930	2,052	106.3
Homeowners in Massachusetts	12,476	10,330	2,146	20.8
Homeowners in all other states	4,357	3,020	1,337	44.3
Other lines in Massachusetts	5,133	3,491	1,642	47.0
Other lines in all other states	142	107	35	32.7
Total net premiums written	$812,510	$702,037	$110,473	15.7
Earned Premiums:				
Personal automobile in Massachusetts	$492,160	$417,186	$ 74,974	18.0%
Personal automobile in all other states	88,587	67,815	20,772	30.6
Commercial automobile in Massachusetts	32,755	26,237	6,518	24.8
Commercial automobile in all other states	3,018	1,081	1,937	179.2
Homeowners in Massachusetts	12,140	10,244	1,896	18.5
Homeowners in all other states	3,875	2,423	1,452	59.9
Other lines in Massachusetts	3,436	3,856	(420)	(10.9)
Other lines in all other states	135	93	42	45.2
Assumed premiums from CAR	51,009	48,046	2,963	6.2
Assumed premiums from other than CAR	1,141	193	948	491.2
Total earned premiums	$688,256	$577,174	$111,082	19.2
Earned premiums in Massachusetts	$540,491	$457,523	$ 82,968	18.1%
Earned premiums assumed	52,150	48,239	3,911	8.1
Earned premiums in all other states	95,615	71,412	24,203	33.9
Total earned premiums	$688,256	$577,174	$111,082	19.2

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The $81.5 million, or 14.6%, increase in Massachusetts personal automobile direct premiums written during the six months ended June 30, 2003 resulted primarily from an 8.0% increase in average written premium per written exposure coupled with a 6.1% increase in the number of exposures written. We attribute the growth in exposures to increased penetration of our independent agents books of business as the overall number of exposures in Massachusetts has had less than 1% growth during the period. The increase in personal automobile and homeowners business in all other states was primarily attributable to book transfers in various states, increased retention of existing business and an increase in the average written premium per exposure. Additionally, the increase in homeowners in all other states was impacted by contraction of authority to write homeowner business by competitors.

Our increase in Massachusetts commercial automobile premiums is directly related to our effort to increase writings in this line of business and from increases in the average rate per policy. Our increase in Massachusetts homeowner premiums is primarily related to an increased number of agents, fewer carriers writing homeowner business, our pricing position in the marketplace and agents writing more homeowner business to achieve a homeowner discount for their customer when we also insure the customer s automobile.

The $111.1 million, or 19.2%, increase in total earned premiums for the six months ended June 30, 2003 as compared to the same period of 2002 was primarily attributable to increases in personal and commercial automobile business.

Net Investment Income

Net investment income is affected by the composition of our investment portfolio and yields on those investments. As depicted in the following table, net investment income for the six months ended June 30, 2003 decreased $2.0 million, or 4.1%, compared to the same period of 2002, principally as a result of a decrease in yield offset by an increase in average invested assets at cost. The decrease in yield is primarily due to lower short-term yields coupled with an environment of lower long-term yields and higher yielding investment securities being called. Net investment income as a percentage of total average investments was 5.5% in the six months ended June 30, 2003 compared to 6.1% for the same period in 2002. After-tax net investment income as a percentage of total average investments was 4.4% and 4.8% in the six months ended June 30, 2003 and 2002, respectively.

	Six Months Ended June 30,	
	2003	**2002**
	(Dollars in thousands)	(Restated)
Investment Return:		
Average month-end investments (at cost)	$1,653,489	$1,557,120
Net investment income before tax	45,812	47,762
Net investment income after-tax	36,706	37,611
Annualized net investment income as a percentage of average net investments (at cost)	5.5%	6.1%
Annualized net investment income after-tax as a percentage of average net investments (at cost)	4.4%	4.8%

Premium Finance and Service Fees

Premium finance and service fees increased $3.2 million, or 32.5%, during the six months ended June 30, 2003, as a result of increased business and a service fee increase on Massachusetts new and renewal business from $3.00 to $4.00 per installment payment, for policies with effective dates on or after July 1, 2002.

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Investment Gains and Losses

Net realized investment gains totaled $60.0 million, or $1.33 per diluted share, for the six months ended June 30, 2003 as compared to net realized investment losses of $35.0 million, or $0.76 per diluted share, for the same period of 2002.

During the second quarter of 2003, we decided to shorten the overall duration of our investment portfolio by reducing our holdings of long-term fixed investments, equities and closed-end preferred stock mutual funds. Primarily as a result of these sales, we realized net investment gains of $37.3 million, or $24.3 million after taxes, in those categories for the six months ended June 30, 2003 compared to a net realized investment loss of $837,000, or $544,000 after taxes, on sales of securities in those categories during the same period of 2002.

Of the $60.0 million total, we recognized net realized investment gains of $39.7 million, or $25.8 million, after taxes, for the six months ended June 30, 2003 attributable to the change in the net asset value of seven closed-end preferred stock mutual funds in which we owned 20% or more as of June 30, 2003 and therefore were required to account for using the equity method of accounting. See Critical Accounting Policies Investments. For the six months ended June 30, 2003, the net realized investment gains attributable to the fund investments that we must account for using the equity method increased $59.1 million as compared to a net realized investment loss of $19.4 million for that category of investments for the same period of 2002. The decline in interest rates during the second quarter of 2003 caused a significant increase in the net asset value of those funds and, as a direct consequence, an increase in the net realized investment gains that we recognized for those investments for the six months ended June 30, 2003.

Our gains on investment securities were partially offset by write-downs for other-than-temporary declines in the market value of certain fixed maturities, preferred stocks and common stocks totaling $15.9 million. The other-than-temporary writedowns consisted primarily of $2.4 million for one municipal bond, $6.5 million for two corporate bonds and $7.0 million for three preferred stocks.

Loss and Loss Adjustment Expenses

Our loss ratio (on a statutory basis) increased to 78.7% for the six months ended June 30, 2003 compared to 75.8% for the same period of 2002. The increase was primarily caused by increased claim frequency of approximately 20% in the Massachusetts automobile line and approximately 50% in the Massachusetts homeowner line, both occurring in the first quarter of 2003 as a result of the severe winter.

The following table sets forth a reconciliation of beginning and ending reserves for losses and loss adjustment expense, net of reinsurance deductions from all reinsurers including CAR.

	Six Months Ended June 30,	
	2003	**2002**
	(Dollars in thousands)	**(Restated)**
Loss and loss adjustment expense reserves, beginning of year, prior to effect of ceded reinsurance recoverable	$678,348	$594,156
Plus incurred losses and loss adjustment expense	543,605	439,551
Less payments	482,254	394,013
Loss and loss adjustment expense reserves prior to effect of ceded reinsurance recoverable	739,699	639,694
Ceded reinsurance recoverable	153,549	115,199
Reserves for losses and loss adjustment expenses at the end of period per financial statements	$893,248	$754,893

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Policy Acquisition Costs

As a percentage of net premiums written, statutory underwriting expenses for our insurance subsidiaries improved to 21.3% for the six months ended June 30, 2003 as compared to 22.6% for the same period of 2002. The improvement was primarily due to a reduction in accrued contingent commissions as a result of the high loss ratio mentioned previously, decreased expenses assumed from CAR as a result of a true-up of estimated expenses to actual expenses, coupled with premium growth exceeding growth in underwriting expenses.

Combined Ratio

For the six months ended June 30, 2003, our statutory combined ratio, which is the sum of our loss ratio and underwriting expense ratio, was 100.0%, compared with 98.4% for the same period of 2002. The increase in the combined ratio was primarily the result of an increase in the loss ratio, partially offset by a decrease in the underwriting ratio.

Income Taxes

Our overall effective tax rate for the six months ended June 30, 2003 was 21.8% as compared to 16.0% for the same period of 2002. In both years, our effective rate was lower than the statutory rate of 35% primarily due to tax-exempt interest and the corporate dividends received deduction. Our 2003 effective rate was also favorably impacted by our ability to utilize $3.9 million of previously unrecognized tax benefits associated with capital loss carry forwards. Our income tax rate for the six months ended June 30, 2002 was impacted by the magnitude of the realized losses during that period.

Change in Accounting Principle

Due to the effect of a change in accounting principle related to SFAS No. 142, we recorded income in the first quarter of 2002, net of taxes, of $11.2 million, or $0.34 per share (diluted). This amount represented the remaining unamortized negative goodwill related to closed-end preferred stock mutual funds and the remaining excess of book value of subsidiary interest over cost relating to the 1999 acquisition of American Commerce. Negative goodwill and the excess of book value of subsidiary interest over cost were created in these acquisitions because the underlying value of the assets purchased exceeded the purchase price. The subsequent recognition of income that occurred as these items were eliminated was not a taxable event but instead became part of the basis of the acquired asset.

Minority Interest in Net Loss of Subsidiary

Effective January 1, 2002, the ownership interests in ACIC Holding Co., Inc. were recapitalized. Prior to the recapitalization at December 31, 2001, we maintained an 80% common stock interest and AAA Southern New England maintained a 20% common stock interest in ACIC Holding. Additionally, all ACIC Holding preferred stock was owned by us. The recapitalization resulted in the redemption of our ACIC Holding preferred stock in exchange for 3,000 additional shares of ACIC Holding common stock. This resulted in an increase in our ACIC Holding common stock interest to 95% with AAA SNE maintaining a 5% ACIC Holding common stock interest, with no preferred stock outstanding.

Net Earnings

Our net earnings for the six months ended June 30, 2003 were $84.4 million compared to net earnings of $32.7 million for the same period of 2002. The increase resulted primarily from a $68.1 million increase in our net realized investment gains after taxes, and a $111.1 million increase in our earned premiums, which together more than offset an increase of $104.1 million in losses and loss adjustment expenses, all as described elsewhere in this section.

As discussed above under Investment Gains and Losses , 60.1% of our net realized investment gains, after-taxes, for the six months ended June 30, 2003 were attributable to the change in the net asset value of

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seven closed-end preferred stock mutual funds that we accounted for using the equity method of accounting. As of the date of this prospectus, we still own four fund investments that we account for using the equity method. If long-term interest rates are higher at September 30, 2003 than they were at June 30, 2003, the respective net asset values of those funds at September 30, 2003 would be less than they were at June 30, 2003, and we would recognize a net realized investment loss for those fund investments. As of the August 31, 2003, long-term interest rates, as reflected by the yield on ten year treasury notes, were significantly higher than they were at June 30, 2003, and as a consequence the aggregate net asset value of our investment in those four funds was $10.8 million less than it was at June 30, 2003. If, as we expect, long-term interest rates at September 30, 2003 are higher than they were at June 30, 2003, we very likely would recognize a net realized investment loss on those four fund investments that may have a material adverse effect on our results of operations for the period ending September 30, 2003.

Year Ended December 31, 2002 compared to Year Ended December 31, 2001 (Restated)

Overview

Our net earnings for the year ended December 31, 2002 were adversely affected primarily by a significant increase in our net realized investment losses and, to a lesser extent, by an increase in our losses and loss adjustment expense, which together more than offset an increase in our earned premiums.

Our after-tax net realized investment losses increased by $62.6 million for the year ended December 31, 2002 compared to the year ended December 31, 2001. The increased losses resulted primarily from:

- the unfavorable impact of the decline in utility common stocks on the net asset values of various closed-end preferred stock mutual funds that we must reflect in our net realized investment losses using the equity method of accounting; and

- write-downs for other-than-temporary declines in the market value of various investment securities.

See Investment Gains and Losses.

Our losses and loss adjustment expenses increased by $128.1 million, or 16.4%, in 2002 compared to 2001. The increase resulted primarily from our premium growth and an increase in our loss ratio (on a statutory basis) to 75.1% for 2002 compared to 74.5% for 2001. See Losses and Loss Adjustment Expenses.

Our earned premiums increased by $166.4 million, or 15.9%, in 2002 compared to 2001, primarily resulting from

- an increase of $102.2 million, or 13.2%, in earned premiums for personal automobile coverage in Massachusetts, primarily because of our acquisition of the personal automobile business of two companies that were exiting that market;

- an increase of $29.9 million, or 25.7%, in earned premiums for personal automobile coverage outside of Massachusetts; and

- an increase of $12.7 million, or 29.6%, in earned premiums for commercial automobile coverage in Massachusetts.

See Premiums.

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Premiums

The following table compares direct premiums written, net premiums written and earned premiums for the years ended December 31, 2002 and 2001:

	Year Ended December 31,			
	2002	2001	$ Change	% Change
	(Dollars in thousands)			
Direct Premiums Written:				
Personal automobile in Massachusetts	$1,032,438	$ 859,922	$172,516	20.1%
Personal automobile in all other states	155,045	122,320	32,725	26.8
Commercial automobile in Massachusetts	74,879	58,088	16,791	28.9
Commercial automobile in all other states	5,151	1,514	3,637	240.2
Homeowners in Massachusetts	87,634	73,254	14,380	19.6
Homeowners in all other states	27,376	18,710	8,666	46.3
Other lines in Massachusetts	23,569	17,885	5,684	31.8
Other lines in all other states	764	714	50	7.0
Total direct premiums written	$1,406,856	$1,152,407	$254,449	22.1
Net Premiums Written:				
Personal automobile in Massachusetts	$1,039,141	$ 864,900	$174,241	20.1%
Personal automobile in all other states	152,796	122,256	30,540	25.0
Commercial automobile in Massachusetts	77,839	60,986	16,853	27.6
Commercial automobile in all other states	4,968	1,477	3,491	236.4
Homeowners in Massachusetts	25,149	20,364	4,785	23.5
Homeowners in all other states	6,142	4,576	1,566	34.2
Other lines in Massachusetts	6,744	4,236	2,508	59.2
Other lines in all other states	235	172	63	36.6
Total net premiums written	$1,313,014	$1,078,967	$234,047	21.7
Earned Premiums:				
Personal automobile in Massachusetts	$ 878,739	$ 776,552	$102,187	13.2%
Personal automobile in all other states	146,381	116,479	29,902	25.7
Commercial automobile in Massachusetts	55,752	43,008	12,744	29.6
Commercial automobile in all other states	3,139	711	2,428	341.5
Homeowners in Massachusetts	22,620	19,119	3,501	18.3
Homeowners in all other states	5,459	3,731	1,728	46.3
Other lines in Massachusetts	6,069	3,290	2,779	84.5
Other lines in all other states	206	158	48	30.4
Assumed premiums from CAR	90,593	80,176	10,417	13.0
Assumed premiums from other than CAR	1,082	428	654	152.8
Total earned premiums	$1,210,040	$1,043,652	$166,388	15.9
Earned premiums in Massachusetts	$ 963,180	$ 841,969	$121,211	14.4%
Earned premiums assumed	91,675	80,604	11,071	13.7
Earned premiums in all other states	155,185	121,079	34,106	28.2
Total earned premiums	$1,210,040	$1,043,652	$166,388	15.9

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The $172.5 million, or 20.1%, increase in Massachusetts personal automobile direct premiums written resulted primarily from increases of 13.8% and 14.0% in the number of Massachusetts personal automobile exposures for liability and physical damage coverage, respectively, and from increases in rates for the coverage types noted below. The components of these changes for 2002 and 2001 were as follows:

Coverage Type	2002 Rate Change(1)	2001 Rate Change(1)
Liability:		
Bodily injury	6.0%	(2.1)%
Personal injury protection	18.7	(12.9)
Property damage to others	3.9	1.0
Physical Damage:		
Collision	4.8	(0.1)
Comprehensive	0.1	(7.6)
Total(2)	5.3	(1.9)

(1) Represents change in our average rate per exposure from our prior year average rate for Massachusetts private passenger automobile premiums.

(2) The total rate change depicted is the result of the weighted average of premiums written for all coverages divided by liability exposures only, due to the fact that all exposures are required to carry liability coverage.

The above percentage changes were primarily the result of rate modifications in the individual coverage components in the 2002 state mandated rates, changes in our safe driver rate deviations, and changes in the distribution of our business by class and territory. The combination of these factors resulted in a 5.3% increase in the average personal automobile premium per exposure in 2002. Despite no change from the previous year for the 2002 state mandated average rates, our increase in the average personal automobile premium per exposure was primarily due to the above-noted changes. Also having an impact was the fact that the announced rate decision did not include the effect of future purchases of new automobiles in the year to which the rate decision applied. In addition, our mix of personal automobile business differs from that of the industry. In 2002, we did not offer our customers safe driver deviations.

Included in the premium increase for Massachusetts personal automobile direct premiums written are premiums that were the result of appointments of new agents. During 2002, we had 127 new appointments, of which 89 were from voluntary agents resulting in an additional $50.5 million in premiums. These new appointments were primarily the result of our agreements to acquire the Massachusetts personal automobile business from Berkshire Mutual Insurance Company and MassWest Insurance Company. See Our Business Agreements for the Transfer of Massachusetts Business from Other Companies in 2002. The remainder of the new appointments resulted from ERPs. Business obtained from new ERPs amounted to $17.0 million during 2002.

The AAA affinity group discount for 2002 was established at 6.0%, which was unchanged from 2001. In 2001, for drivers who qualified, our AAA affinity group discount and safe driver deviations could be combined for up to a 7.9% reduction from state-mandated rates. In 2002, we did not offer a safe driver discount.

Although direct premiums written for personal automobile insurance in states other than Massachusetts increased $32.7 million, or 26.8%, in 2002, an overall depressed rate environment and adverse development of prior year reserves resulted in diminished underwriting profits. We continue to evaluate a number of other state rating structures, have filed for increases in several states and will seek additional rate increases where appropriate. Personal automobile direct premiums written by American Commerce increased $26.6 million, or 31.3%, to $111.8 million in 2002 as compared to $85.1 million in 2001, due primarily to book rollovers of business from existing agents, partially offset by decreases in states where we are not actively pursuing writings. Personal automobile direct premiums written from Commerce West increased $3.9 million, or

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10.5%, to $41.1 million in 2002 as compared to $37.2 million in 2001. Both companies primarily target preferred insurance risks and write predominantly personal automobile insurance. Commerce West s recent growth is attributable to preferred personal automobile business. Personal automobile policies for both companies are written primarily for a policy term of six months.

Direct premiums written for Massachusetts commercial automobile insurance increased by $16.8 million, or 28.9%, in 2002 as compared to 2001, due primarily to an increase of approximately 14.0% in the number of policies written, combined with a 13.0% increase in the average commercial automobile premium per policy. The increase in premium per policy was attributable to demand for insurance exceeding supply in the commercial automobile market, as well as our own increase of volume of larger commercial automobile accounts. In 2002, we experienced an increase of approximately $1.9 million from policies with premiums in excess of $50,000. In addition, base rates for other voluntary commercial automobile policies have increased moderately, and a reduction in Individual Risk Premium Modification, or IRPM, credits has occurred, favorably affecting average premiums per policy. In addition, we experienced approximately a 3.0% increase in rates for policies written through CAR. The increased business was attributable to our initiative to expand writings.

Direct premiums written for Massachusetts homeowners insurance increased by $14.4 million, or 19.6%, in 2002 as compared to 2001, due primarily to a 10.8% increase in the number of Massachusetts policies written coupled with a 7.3% increase in the average Massachusetts premium per policy. Our increase in Massachusetts homeowner premiums is primarily related to several factors:

- an increased number of agents;
- fewer carriers writing homeowner business;
- our pricing position in the marketplace; and
- the bundling of homeowners insurance with automobile insurance, which provides a homeowner discount to customers.

Homeowners insurance written by American Commerce in other states increased $8.7 million, or 46.3%, to $27.4 million in 2002 due primarily to book rollovers of business from existing agents, and the impact caused by contraction of authority to write homeowner business by competitors. Homeowner policies in all states are written primarily for a policy term of one year.

The $234.0 million, or 21.7%, increase in net premiums written was primarily due to the growth in direct premiums written as described above offset by an increase in premiums ceded to CAR and the quota share agreement. Net premiums written for homeowners insurance in all other states increased $1.6 million, with net premiums written of $6.1 million in 2002 as compared to $4.6 million in 2001.

The $166.4 million or 15.9% increase in earned premiums during 2002 as compared to 2001, was primarily due to increases in written premiums as described above and 2001 written premiums being earned in 2002.

Net Investment Income

As depicted in the accompanying table, net investment income before taxes for 2002 decreased $1.1 million, or 1.1%, as compared to 2001, principally as a result of a decrease in yield partially offset by an increase in average invested assets at cost. The decrease in yield was primarily due to lower short-term yields, coupled with an environment of lower long-term yields and higher yielding investment securities being called. During 2002, we purchased approximately $142 million of Fannie Mae (FNMA) securities. We believe these securities will have a duration of less than three years. This will allow us to achieve higher yields until longer term investments are acquired. Net investment income as a percentage of total average investments was 6.3% in 2002 compared to 6.6% in 2001. Net investment income after-tax, as a percentage of total average investments, was 5.0% in 2002 and 5.3% in 2001.

Investment Return:	Year Ended December 31, 2002	2001
		(Restated)
	(Dollars in thousands)	
Average month-end investments (at cost)	$ 1,576,219	$ 1,506,485
Net investment income before tax	98,466	99,563
Net investment income after-tax	78,236	79,124
Net investment income as a percentage of average net investments (at cost)	6.3%	6.6%
Net investment income after-tax as a percentage of average net investments (at cost)	5.0%	5.3%

Premium Finance and Service Fees

Premium finance and service fees increased $3.7 million, or 20.6%, during 2002, as a result of increased business and a service fee increase on Massachusetts new and renewal business from three dollars to four dollars per installment payment, for policies with effective dates on or after July 1, 2002.

Investment Gains and Losses

Net realized investment losses totaled $82.4 million during 2002 as compared to $10.6 million in 2001. Net realized investment losses during 2002 were primarily centered in two areas: closed-end preferred stock mutual funds and other-than-temporary impairments. Declines in the market values of utility common stocks held by various closed-end preferred stock mutual funds totaling $44.6 million were the primary reasons for these losses. We reflect these declines through realized losses because our significant level of ownership requires the use of the equity method of accounting for these funds. See Critical Accounting Policies Investments above for more information on our use of the equity method of accounting for these funds.

The realized losses for 2002 also resulted from write-downs for other-than-temporary declines in the market value of certain fixed maturities, preferred and common stocks totaling $32.1 million. Our management focuses on the potential impairment of investments for other-than-temporary declines in market value. During 2002, an impairment in an investment was deemed to be other-than-temporary when a security s market value had diminished by more than 25% of cost for two consecutive calendar quarters. If the contractual terms of the security were being complied with, management performed a cash flow valuation to determine the potential impairment of the security. If the security was deemed impaired, we adjusted the security s cost to market value by recording a realized loss based on publicly available information or, in the absence of such information, to a value based on cash flow modeling. See Critical Accounting Policies Investments above for more information about our current policy for determining whether an other-than-temporary decline in investment securities has occurred.

During 2002, $3.7 million in realized investment losses were also incurred related to our investments in venture capital funds. These investments primarily provide seed capital for start-up companies with emerging high technology initiatives in the financial services industry. These investments are made in limited partnerships and our exposure to loss is limited to our actual investment. Investments in these venture capital funds are accounted for on an equity basis.

Losses and Loss Adjustment Expenses

Our loss ratio (on a statutory basis) increased to 75.1% in 2002 as compared to 74.5% in 2001. The primary reasons for this increase were higher private passenger automobile losses from CAR as a result of increased participation in CAR and higher CAR loss ratios, coupled with an increase in the frequency of personal automobile bodily injury claims compared to last year. Another factor in the increase resulted from business written outside of Massachusetts for which the loss ratio increased to 86.4% during 2002 as compared to 84.6% for 2001. These factors were somewhat offset by a lower physical damage claim frequency and a lower loss ratio in the Massachusetts commercial automobile line.

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The following table sets forth a reconciliation of beginning and ending reserves for losses and loss adjustment expense, net of reinsurance deductions from all reinsurers including CAR, as shown in our consolidated financial statements for the years indicated.

	Year Ended December 31,	
	2002	2001
		(Restated)
	(Dollars in thousands)	
Loss and loss adjustment expense reserves, beginning of year, prior to effect of ceded reinsurance recoverable	$594,156	$585,867
Incurred losses and loss adjustment expenses:		
Provision for insured events of the current year	924,206	816,951
Decrease in provision for insured events of prior years	(14,437)	(35,320)
Total incurred losses and loss adjustment expenses	909,769	781,631
Payments:		
Losses and loss adjustment expenses attributable to insured events of the current year	539,555	487,918
Losses and loss adjustment expenses attributable to insured events of prior years	286,022	285,424
Total payments	825,577	773,342
Loss and loss adjustment expense reserves prior to effect of ceded reinsurance recoverable	678,348	594,156
Ceded reinsurance recoverable	137,278	101,036
Reserves for losses and loss adjustment expenses at the end of year per financial statements	$815,626	$695,192

The decrease in provision for insured events of prior years represents redundancies for reserves established for prior years. This decrease in provision was principally the result of re-estimation of unpaid losses and loss adjustment expenses principally on the personal automobile, commercial automobile and homeowners lines of business.

Policy Acquisition Costs

As a percentage of net premiums written, our statutory underwriting expenses decreased to 23.6% in 2002 as compared to 24.2% in 2001. The improvement was primarily due to a lower mandated Massachusetts personal automobile commission rate in 2002 as compared to 2001, and to lower general underwriting expenses. Another factor in the decrease resulted from business written outside of Massachusetts where the underwriting expense ratio decreased to 29.7% for 2002 as compared to 32.6% for 2001. These factors were partially offset by higher contingent commission expenses and higher insolvency assessments. The 2002 underwriting ratio includes a $4.5 million charge, as compared to a $3.1 million charge in 2001, representing our allocation from the Massachusetts Insurers Insolvency Fund.

Combined Ratio

Our statutory combined ratio was 98.7% for both 2002 and 2001. This resulted in an underwriting profit of 1.3% for both 2002 and 2001. This was the result of the factors mentioned above.

Income Taxes

Our effective tax rate was 32.8% and 17.1% for the years ended December 31, 2002 and 2001, respectively. In 2002, the effective tax rate was affected by the write-off of deferred tax assets of $14.8 million. This amount was comprised of $10.9 million from the write-off of a deferred tax asset

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associated with realized losses on our closed-end preferred stock mutual funds that were ineligible for a tax benefit and $3.9 million of valuation allowance associated with our inability to claim a portion of our realized losses against prior years realized gains. In 2001, the effective rate was lower than the statutory rate of 35% primarily due to tax-exempt interest income and the corporate dividends received deduction.

Change in Accounting Principle

Due to the effect of the change in accounting principle related to SFAS No. 142 discussed earlier, we recorded income in the first quarter of 2002, net of taxes, of $11.2 million, or $0.34 per share (diluted).

Minority Interest in Net Loss of Subsidiary

Effective January 1, 2002, the ownership interests in ACIC Holding Co., Inc. were recapitalized. Prior to the recapitalization at December 31, 2001, we maintained an 80% common stock interest and AAA Southern New England maintained a 20% common stock interest in ACIC Holding. Additionally, all ACIC Holding preferred stock was owned by us. The recapitalization resulted in the redemption of our ACIC Holding preferred stock in exchange for 3,000 additional shares of ACIC Holding common stock. This resulted in an increase in our ACIC Holding common stock interest to 95% with AAA SNE maintaining a 5% ACIC Holding common stock interest, with no preferred stock outstanding.

Net Earnings

Our net earnings decreased $43.5 million, or 48.2%, to $46.8 million during 2002 as compared to $90.3 million in 2001, resulting primarily from an increase in our net realized investment losses of $71.8 million and an increase in our losses and loss adjustment expenses of $128.1 million, which together more than offset an increase of $166.4 million in our earned premiums, all as previously described in this section. Net earnings for 2002 included income, net of taxes, of $11.2 million due to the effect of a change in accounting principle related to SFAS No. 142. See Change in Accounting Principle.

Year Ended December 31, 2001 (Restated) Compared to Year Ended December 31, 2000

Overview

Our net earnings for the year ended December 31, 2001 were adversely affected primarily by our net realized investment losses and, to a lesser extent, by an increase in our losses and loss adjustment expense, which together more than offset an increase in our earned premiums.

Our net realized investment losses totaled $10.6 million for 2001, representing a decline of $40.2 million, or 136.0%, compared to net realized investment gains of $29.6 million in 2000. Our net realized investment losses in 2001 resulted primarily from:

- a decline of $9.1 million in the value of our investment in a venture capital fund that we began accounting for using the equity method of accounting in 2001; and

- a decline of $22.0 million in the net asset values of various closed-end preferred stock mutual funds that we also accounted for using the equity method of accounting.

See Investment Gains and Losses.

Our losses and loss adjustment expenses increased by $95.5 million, or 13.9%, in 2001 compared to 2000. The increase resulted primarily from our premium growth and an increase in our pure loss ratio (on a statutory basis and excluding LAE) to 65.4% for 2001 compared to 63.1% for 2000, due primarily to more adverse weather conditions in 2001 in our Massachusetts market. See Losses and Loss Adjustment Expenses (2001 Restated).

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Our earned premiums increased by $89.2 million, or 9.3%, in 2001 compared to 2000, resulting primarily from:

- an increase of $61.6 million, or 8.6%, in earned premiums for personal automobile coverage in Massachusetts;
- an increase of $16.4 million, or 16.4%, in earned premiums for personal automobile coverage outside of Massachusetts; and
- an increase of $10.5 million, or 32.1%, in earned premiums for commercial automobile coverage in Massachusetts.

See Premiums.

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Premiums

The following table compares direct premiums written, net premiums written and earned premiums for the years ended December 31, 2001 and 2000:

	Year Ended December 31,			
	2001	2000	$ Change	% Change
	(Dollars in thousands)			
Direct Premiums Written:				
Personal automobile in Massachusetts	$ 859,922	$ 827,180	$32,742	4.0%
Personal automobile in all other states	122,320	103,496	18,824	18.2
Commercial automobile in Massachusetts	58,088	43,243	14,845	34.3
Commercial automobile in all other states	1,514	104	1,410	*
Homeowners in Massachusetts	73,254	65,662	7,592	11.6
Homeowners in all other states	18,710	16,498	2,212	13.4
Other lines in Massachusetts	17,885	14,860	3,025	20.4
Other lines in all other states	714	606	108	17.8
Total direct premiums written	$1,152,407	$1,071,649	$80,758	7.5
Net Premiums Written:				
Personal automobile in Massachusetts	$ 864,900	$ 839,394	$25,506	3.0%
Personal automobile in all other states	122,256	103,719	18,537	17.9
Commercial automobile in Massachusetts	60,986	44,848	16,138	36.0
Commercial automobile in all other states	1,477	104	1,373	*
Homeowners in Massachusetts	20,364	17,547	2,817	16.1
Homeowners in all other states	4,576	(1,658)	6,234	*
Other lines in Massachusetts	4,236	4,916	(680)	(13.8)
Other lines in all other states	172	41	131	319.5
Total Net Premiums Written	$1,078,967	$1,008,911	$70,056	6.9
Earned Premiums:				
Personal automobile in Massachusetts	$ 776,552	$ 714,972	$61,580	8.6%
Personal automobile in all other states	116,479	100,101	16,378	16.4
Commercial automobile in Massachusetts	43,008	32,548	10,460	32.1
Commercial automobile in all other states	711	19	692	*
Homeowners in Massachusetts	19,119	17,364	1,755	10.1
Homeowners in all other states	3,731	4,186	(455)	(10.9)
Other lines in Massachusetts	3,290	3,434	(144)	(4.2)
Other lines in all other states	158	162	(4)	(2.5)
Assumed Premiums from CAR	80,176	81,300	(1,124)	(1.4)
Assumed Premiums from other than CAR	428	397	31	7.8
Total earned premiums	$1,043,652	$ 954,483	$89,169	9.3
Earned premiums in Massachusetts	$ 841,969	$ 768,318	$73,651	9.6%
Earned premiums assumed	80,604	81,697	(1,093)	(1.3)
Earned premiums in all other states	121,079	104,468	16,611	15.9
Total earned premiums	$1,043,652	$ 954,483	$89,169	9.3

* Calculation is not meaningful.

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The $32.7 million, or 4.0%, increase in Massachusetts personal automobile direct premiums written resulted primarily from increases of 5.8% and 7.1% in the number of Massachusetts personal automobile exposures for liability and physical damage coverage, respectively, partially offset in 2001 by decreases in rates for the coverage types noted below. The components of these changes from the previous year for 2001 and 2000 were as follows:

Coverage Type	2001 Rate Change(1)	2000 Rate Change(1)
Liability:		
Bodily injury	(2.1)%	1.0%
Personal injury protection	(12.9)	6.4
Property damage to others	1.0	20.8
Physical Damage:		
Collision	(0.1)	1.7
Comprehensive	(7.6)	2.4
Total(2)	(1.9)	6.2

(1) Represents change in our average rate per exposure from our prior year average rate for Massachusetts private passenger automobile premiums.

(2) The total rate change depicted is the result of the weighted average of premiums written for all coverages divided by liability exposures only, due to the fact that all exposures are required to carry liability coverage.

The above percentage changes were primarily the result of rate modifications in the individual coverage components in the 2001 state mandated rates, offset by changes in our safe driver rate deviations, and changes in the distributions of the business written by us. The combination of these factors resulted in a 1.9% decrease in the average personal automobile premium per exposure in 2001. Despite the 2001 state mandated average rate decrease of 8.3%, the smaller decrease in the average personal automobile premium per exposure was primarily due to the above-noted changes. Also having an impact was the fact that the announced rate decision did not estimate future purchases of new automobiles in the year to which the rate decision applied. Additionally, our mix of personal automobile business differs from that of the industry. In 2001, we offered our customers safe driver deviations of 2.0% to drivers with SDIP classifications of Step 9, those classified as the safest drivers, and 0.0% for Step 10, those classified as the next safest drivers (6.0% for Step 9 and 2.0% for Step 10 in 2000).

The AAA affinity group discount for 2001 was established at 6.0%, which was unchanged from 2000. In 2001, for drivers who qualified, our AAA affinity group discount and safe driver deviations could be combined for up to a 7.9% reduction from state mandated rates, as compared to a reduction of up to 11.6% in 2000.

Personal automobile direct premiums written in other states increased $18.8 million, or 18.2%; however, an overall depressed rate environment resulted in diminished underwriting profits. Personal automobile direct premiums written by American Commerce increased $7.3 million, or 9.4%, to $85.1 million as compared to $77.8 million due primarily to book rollovers of business from existing agents, partially offset by decreases in states where we are not actively pursuing writings. Personal automobile direct premiums written from Commerce West increased $11.5 million, or 44.5%, to $37.2 million as compared to $25.7 million.

Direct premiums written for Massachusetts commercial automobile insurance increased by $14.8 million, or 34.3%, in 2001 due primarily to an increase of approximately 9.0% in the number of policies written, combined with a 23.5% increase in the average commercial automobile premium per policy. The increase in premium per policy was attributable to a hardening of the commercial automobile market, as well as our increasing our volume of larger commercial automobile accounts. We experienced an increase of approximately $3.7 million in 2001 from policies with premiums in excess of $50,000. In addition, base rates for other voluntary commercial automobile policies increased moderately during 2001, and a reduction in

Individual Risk Premium Modification, or IRPM, credits occurred, favorably affecting average premium per policy. In addition, we experienced an increase of approximately 10% in rates for policies written through CAR. The increased business was attributable to our initiative to expand writings.

Direct premiums written for Massachusetts homeowners insurance increased by $7.6 million, or 11.6%, in 2001 due primarily to a 6.4% increase in the number of Massachusetts policies written coupled with a 5.0% increase in the average Massachusetts premium per policy. The increase in business was primarily attributable to existing and newly appointed agents. Homeowners insurance written by American Commerce in other states increased $2.2 million, or 13.4%, to $18.7 million in 2001 due primarily to book rollovers of business from existing agents.

The $70.1 million, or 6.9%, increase in net premiums written was primarily due to the growth in direct premiums written as described above partially offset by an increase in premiums ceded to CAR and an increase in premiums ceded to reinsurers other than CAR. Net premiums written for homeowners in all other states increased $6.2 million, with net premiums written of $4.6 million in 2001, as compared to a loss of $1.7 million in net premiums in 2000. The reason for negative written premiums in 2000 was due to American Commerce joining the quota share reinsurance agreement effective January 1, 2000. An unearned premium transfer of $6.0 million occurred effective January 1, 2000, which had a direct impact on net written premiums.

The $89.2 million, or 9.3%, increase in earned premiums during 2001 as compared to 2000, was primarily due to increases in written exposures for Massachusetts personal automobile liability and physical damage, coupled with an increase in earned premium per exposure. The increase in earned premium per exposure (versus a decrease in written premium per exposure) occurred because of the time lag in earning the premium once it is written. This resulted in a $61.6 million, or 8.6%, increase in Massachusetts personal automobile earned premium.

Net Investment Income (2001 Restated)

As depicted in the following table, net investment income for 2001 increased $2.8 million, or 2.9%, compared to 2000, principally as a result of an increase in average invested assets (at cost), partially offset by a decrease in yield. The decrease in yield was primarily due to lower short-term yields on larger cash and cash equivalent balances, coupled with an environment of higher yielding fixed maturities being called. Net investment income as a percentage of total average investments was 6.6% in 2001 compared to 6.9% in 2000. Net investment income after tax as a percentage of total average investments was 5.3% and 5.7% for 2001 and 2000, respectively.

	Year Ended December 31,	
Investment Return	**2001**	**2000**
	(Restated)	
	(Dollars in thousands)	
Average month-end investments (at cost)	$1,506,485	$1,395,159
Net investment income before tax	99,563	96,830
Net investment income after-tax	79,124	79,547
Net investment income as a percentage of average net investments (at cost)	6.6%	6.9%
Net investment income after-tax as a percentage of average net investments (at cost)	5.3%	5.7%

Premium Finance and Service Fees

Premium finance and service fees increased $2.6 million, or 17.0%, during 2001, as a result of increased premiums as discussed earlier.

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Amortization of Excess of Book Value of Subsidiary Interest Over Cost

As a result of the acquisition of American Commerce, the amount representing the excess of the fair value of the net assets acquired over the purchase price at January 29, 1999 was $16.9 million. During 2001 and 2000, this amount was amortized into revenue on a straight-line basis over a five-year period. The amount amortized into revenue in both 2001 and 2000 was $3.4 million.

Investment Gains and Losses

Net realized investment losses totaled $10.6 million during 2001 as compared to gains of $29.6 million in 2000. Of the net realized losses during 2001, $9.1 million was a result of our venture capital fund investments. These investments primarily provide seed capital for start-up companies with emerging high technology initiatives in the financial services industry. These investments are made in limited partnerships and our exposure to loss is limited to the actual investment. In 2001, we began to account for these investments on an equity basis. The equity in the operating results of these funds has been reflected in realized gains and losses. Prior to this change, the operating results were not material and were therefore reflected in accumulated other comprehensive income and loss.

Our net realized investment losses for 2001 also reflect the decline in the net asset value of seven closed-end preferred stock mutual funds that we must categorize as realized investment gains using the equity method of accounting. See Critical Accounting Policies Investments above. Our net realized investment gains for 2000 includes $26.6 million of net realized investment gains attributable to the fund investments that we must account for using the equity method. For 2001, we recognized $4.6 million of net investment gains attributable to such funds, resulting in a $22.0 million, or 82.8%, decrease in our reported net investment gains for such investments in 2001 compared to 2000.

Loss and Loss Adjustment Expenses (2001 Restated)

Losses and LAE incurred increased $95.5 million, or 13.9%, in 2001 as compared to 2000. Our Massachusetts operations experienced declining underwriting results due primarily to increased losses in the homeowners property business and in comprehensive personal automobile, due to more adverse weather conditions in 2001 compared to 2000. Our pure loss ratio of net incurred losses, excluding LAE, to premiums earned on Massachusetts personal automobile was 65.4% in 2001 compared to 63.1% in 2000. The commercial automobile pure loss ratio increased to 61.8% in 2001 compared to 59.7% in 2000. These increases were due primarily to higher bodily injury losses and to higher physical damage losses coupled with worse experience in the business assumed from CAR during this period. For Massachusetts homeowners (gross of reinsurance), the pure loss ratio was 47.6% in 2001 compared to 40.0% in 2000. This increase was the result of more claims for Massachusetts homeowner business due to less favorable weather conditions, primarily during the first six months of 2001. Pure loss ratios for homeowners insurance written by subsidiaries in other states increased to 67.5% in 2001 compared to 62.9% in 2000.

The loss ratio (on a statutory basis) for Commerce West and American Commerce was 85.1% and 84.4%, respectively, in 2001, compared to 69.3% and 84.5% respectively, in 2000. The increase in the loss ratio for Commerce West was primarily attributable to a substantial increase in non-standard automobile writings with loss ratios that are significantly higher than for standard automobile policies.

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The following table sets forth a reconciliation of beginning and ending reserves for losses and loss adjustment expense, net of reinsurance deductions from all reinsurers including CAR, as shown in our consolidated financial statements for the periods indicated.

	Year Ended December 31,	
	2001	2000
	(Restated)	
	(Dollars in thousands)	
Loss and loss adjustment expense reserves, beginning of year, prior to effect of ceded reinsurance recoverable	$585,867	$558,779
Incurred losses and loss adjustment expenses:		
Provision for insured events of the current year	816,951	728,582
Decrease in provision for insured events of prior years	(35,320)	(42,425)
Total incurred losses and loss adjustment expenses	781,631	686,157
Payments:		
Losses and loss adjustment expenses attributable to insured events of the current year	487,918	402,040
Losses and loss adjustment expenses attributable to insured events of prior years	285,424	257,029
Total payments	773,342	659,069