

**COASTAL INSURANCE RISK RETENTION GROUP, INC.  
CIRRG**

**STOCKHOLDERS' MEETING**

**MAY 17, 2007**

**Presentation by:**

**Melvin L. Capell CPCU, MBA, ARM  
President/CEO**

**Opening**

Good Morning, Mr. Chairman, Board Members, Stockholders, Insureds, Staff and Guest - it is my privilege to have this opportunity to report to you on the status of Coastal Insurance Risk Retention Group, Inc. (hereinafter I will call it CIRRG). Your interest, shown by your attendance at this meeting, is the heart of what has made CIRRG successful. I thank you for your support and involvement.

**2006 Results**

As you have already heard from our Certified Public Accountants, the bottom line is that CIRRG operated at a profit for the year 2006. This is the third consecutive year that I have had the privilege of making the statement that CIRRG has had a profitable year.

During 2006, CIRRG took in \$15.46 million of "Gross Premiums Written" and \$938.6 thousand of "Net Investment Gain". After subtracting operating expenses and the cost of all years claims activity that occurred during 2006 the "Income Before Income Taxes" for 2006 was \$2.996 million. CIRRG paid \$1.17 million of "Federal Income Taxes" leaving a "Net Income" of \$1.8 million.

**Transparency**

This is a good point to address a subject that is getting a lot of attention in the news media. That subject is "Transparency". "Transparency" is the term which describes the ability of stockholders, insureds, investors, employees and the public to clearly see what is happening in a corporation. What is the real financial condition of the corporation? Is the corporation making its stockholders fully aware of the current positives and negatives of the financial condition of the corporation? How truthful are the statements made by executives of the corporation? In other words, is the true condition of the corporation easy to see through clear windows of information? Or, is the

view hindered by cloudy or opaque windows to the information; thus, giving those trying to review the condition of the company, a distorted image of the actual situation. Or, worst of all – is the view of the actual condition totally blocked and replaced by false images. Enron is a well known example of this situation.

The Board of Directors has set a clear and definitive standard for CIRRG. Management is to be open and fully transparent. We are to present sufficient and unaltered information to the Board, Stockholders and insureds so that they know the true condition of CIRRG. We sincerely hope that this is apparent to you our Stockholders and insureds. To give a couple of examples:

1. Our Accountants are at this meeting presenting the findings of their 2006 audit. You, the Stockholders, can ask them questions without any restraints or hindrances.
2. In our loss reports, the insureds are shown the full incurred cost of each claim including the loss reserves. Additionally, we encourage you to call our claims staff if you would like additional information on any claim.

## **Financial Strength**

Each of these examples includes information that is very important to the financial reports. In talking about the financial condition of CIRRG, we often tell you that CIRRG is “Financially Strong”. What does this mean? How is it measured?

The dominant expense of an insurance company is the cost of claims. Of the \$7.5 million of “Total Underwriting Deductions” in the 2006 financials, \$5.6 million was “Losses and Loss Adjustment Expenses Incurred”. That is 75% of all of CIRRG’s expenses. Even though this is a large figure, the question should be asked – Is it enough? In studying the cause of failure or financial weakening of insurance companies, almost every time, the cause will be inadequate reserves to pay the claims. Adding reserve amounts to past year claims is treated as a current year financial cost; the adding of these cost causes the subject insurance company to take major hits to its financial position. This was painfully the situation in the case of the Reciprocal of America. “Strength” means that there are sufficient reserves to pay claims with the added financial capability to add to those reserves without significantly changing the financial condition of the company.

Let us look at this in more detail. And, contrast CIRRG’s current situation to the causes of the Reciprocal of America failure.

The first line of protection to having sufficient money to pay all claims is “Case Reserves”. A case reserve is the amount of money that the insurance company sets aside to settle a specific claim. Each time that a new claim is reported, the claims staff reviews the claim. Based on their past experience and the facts of the claim, they set a reserve amount which they feel will be sufficient to settle that claim. If the claim stays open for months or years, the claims staff periodically reviews the reserve for adequacy. If they feel that the reserve is too low or too high they will adjust the amount of the reserve as needed. In the case of large reserves, there are levels of authority or approval. In claims where the reserve gets to \$25,000 or higher; additional levels of management or the Board must approve the claim reserve before it can be changed. In CIRRG, management

keeps a close eye on significant reserve changes, looking for patterns of repeated reserve increases or reductions. Either pattern indicates the potential for difficulties with a larger segment of the case reserves.

At ROA, management was intentionally and artificially lowering case reserves to increase the profit image. In the end, their claim case reserves had no resemblance to the actual value of those claims.

A second line of protection is provided by IBNR – Incurred But Not Reported – reserves. These reserves are developed by the coordinated efforts of management and actuaries. The actuaries use sophisticated, mathematical trending models to predict the ultimate claim cost of all the claims of each year. As an example, the actuaries analyzed the 2004 claims as of December 31, 2006 in determining how much they felt it would ultimately cost to settle all of the 2004 claims. Management then works with the actuaries in selecting a projected ultimate cost of claims for each year. The ultimate claim cost minus the sum of what has already been paid plus the case reserves equals CIRRG's IBNR reserve. This amount provides financial protection for the adverse development of a few special claims. We cannot accurately identify which claims will adversely develop. But, based on many years of data and experience the actuaries can predict the ultimate cost of all claims as a group.

There are several bodies that carefully analyze these ultimate claim cost for adequacy. CIRRG uses an outside actuary – PricewaterhouseCoopers – to assist in the preparation of these figures for all years of operation, on an annual basis. An actuary's reputation is dependent on the quality and accuracy of their work. Additionally, the Certified Public Accountants are required by their audit standards to independently review the adequacy of the ultimate claim cost figures as part of their audit. Then, in addition to all the above, reports are submitted to National Association of Insurance Commissioners (NAIC) and the Alabama Department of Insurance for their review. They also determine if the ultimate claims cost figures are adequate to pay all claims. Just a side, the IRS is also looking at these figures, but for a different reason. They do not want CIRRG to be hiding profits from taxation. Therefore, they are looking to see if the amounts are overstated.

In the case of ROA, IBNR was being intentionally and artificially kept at a low, inadequate level. None of the reviewing bodies were reporting these inadequacies; until the end. At that point, they all did.

A third line of protection is reinsurance. CIRRG purchases reinsurance for claims that exceed \$250,000 in cost. In other words, once a claims' cost reaches a total of \$250,000 the reinsurance program starts to reimburse CIRRG for the cost above the \$250,000. Therefore, no one claim should cause CIRRG a significantly adverse financial hit.

In the case of ROA, they had several layers of reinsurance programs. The first layer was inter-company between companies within the ROA organization. When one company got in trouble, it added to the troubles and downfall of the other companies. The second layer of reinsurance was with an outside reinsurance company. However, as the receiver has taken steps to recover claim cost, anticipated to be covered by reinsurance, they have discovered that there were conditions added to the reinsurance agreements not made available to the ROA Board or regulators. These conditions severely erode the amount of reinsurance recovery actually available.

Finally, above and beyond all the other lines of protection is a sum of money within CIRRG that is not committed to any other liability. This is the “Surplus” figure shown on the financial balance sheet report. In your 2006 report, this amount is \$13.9 million. All of us can take some comfort that this amount is there to give us additional protection – Just In Case.

CIRRG continues to maintain adequate case reserves and IBNR reserves. We have reinsurance with financially sound reinsurance companies. And, CIRRG’s “Surplus” is being maintained at a financially sound level at the direction of the Board. These are the reasons that we can tell you confidently that the financial position of CIRRG has grown stronger each year.

## **Activity Report**

During last years Stockholders’ Meeting, I talked about 3 projects which were underway. I would like to update you on those projects.

1. Warehousing Project. This computer project is now on line. Basic reports are being produced utilizing the data stored in the computer warehouse. However, the project is still ongoing and more reports are being designed or implemented.
2. Coastal Insurance Services, Inc. (CIS). We have had some success in adding accounts to the insurance agency operation and in obtaining new contracts for underwriting and computer services. Marketing efforts continue to grow this side of our operations.
3. Listening. Management has made staff aware that it is important to listen to our clients and to report ideas and suggestions for improvement to their managers. I hope that each of you could give us an example of where CIRRG’s staff has listened to you or someone from your organization.

## **Plans For The Coming Year**

For the coming year, the following projects are underway to improve CIRRG.

1. Strategic Planning Program. The Board and Management are working together to develop a five year strategic plan that will enhance CIRRG’s ability to remain healthy and profitable going into the future. The strategic planning program consist of several pieces including an outside facilitator, a structured analysis of each profit center and a computer model that projects the impact of various operating scenarios.
2. Profit Return Program. CIRRG has reached a financial position which will allow it to start returning some of the profits to the Stockholders. A profit return program is being developed which will continue to build “Surplus”, while taking a portion of projected profits and returning them to the Stockholders. As this program is being developed, we are working closely with outside legal counsel and our auditors to ensure that the program is in compliance with applicable laws and financial reporting standards. The

completed program will be presented to the Board for their review and approval in time to be effective this year.

3. Paperless Liability Claims Operation. This is a new operational technique being used by progressive insurance operations. By use of computer imaging and on line data storage, all claims documents become instantly available to the claims staff anywhere they have access to a computer. It will also reduce the storage space needed to keep physical files.

### **Closing**

In summary, it is a pleasure to tell you that Coastal Insurance Risk Retention Group, Inc. is healthy and financially secure. With this, it can be proudly stated that the future for CIRRG is bright and positive.

Mr. Chairman that concludes my comments.