First Monetary Mutual Limited

Twenty-Fourth Annual Shareholders Meeting
Monday, 15th June 2009
The Fairmont Southampton Princess Hotel
Southampton, Bermuda

Chartered in 1986, First Monetary is a Bermuda based mutual insurance company owned and operated by commercial banks, savings banks and savings and loan associations in the states of New York and Pennsylvania. Two distinctively unique Bermuda symbols serve as marquees for First Monetary's Annual Shareholder's meeting. The Longtail Tern, a native bird, connotes beauty and freedom. The Bermuda moongate, a coral-stone arch shaped like a full moon, conveys unity, peace and happiness.

Agenda Item Five [A]

President's Report

Risk Management: The Black Swan

Welcome Home!!

> "The story that I have to tell is marked all the way through by a persistent tension between those who assert that the best decisions are based on quantification and numbers, determined by the patterns of the past, and those who base their decisions on more subjective degrees of belief about the uncertain future. This is a controversy that has never been resolved."

FROM THE INTRODUCTION TO "AGAINST THE GODS: THE REMARKABLE STORY OF RISK,"
BY PETER L. BERNSTEIN

These lines, excerpted from a very relevant book distributed at our last shareholders meeting, expertly summarize two very different approaches to risk management. – one long established, and one that has more recently come into vogue. Differences of opinion have emerged between "quants", those who develop fantastically complex mathematical models for measuring risk in their portfolios, and "quals", those who rely on a more subjective analysis of this subject.

The quants are scientists and mathematicians who popularized the V@R concept in the early 1990's. V@R — Value at Risk -- is built around statistical ideas and probability theories established centuries ago. The big selling point for devotees is that V@R expresses risk as a single number – and a dollar figure at that.

The principal purpose of V@R is to measure the boundaries of risk in a financial portfolio over short periods. Fashioned as a statement, V@R would be expressed in terms that read something like – "If you have $25 million of weekly V@R, over the next week, there is a 99 percent chance your portfolio won't lose $25 million".

A portfolio could consist of equities, bonds, derivatives or any of these in combination. One reason V@R became popular is that it is the only commonly used risk measure that can be applied to just about any asset class. V@R analyzes multiple variables traders face every day, including diversification, leverage and volatility.

Another reason V@R is appealing is that it can measure two different types of risk, individual risk — the amount of risk contained in a single trader's portfolio, and firm-wide risk, a measurement that combines the V@Rs of all trading desks in an aggregate number. The firm-wide figure is among the first that top executives review at the close of market trading each day.

What V@R fails to address adequately is the exception case, the so-called "outlier" percentage if you recall your high school math. As recent events in the financial markets have proven, even a 99% certainty figure is far from enough to adequately predict a 1% event.

2008's featured risk management author is Nassim Taleb. In his work, "The Black Swan" *(there's a copy in your welcome package!),* Taleb defines outliers as events that fall outside normal expectations. Most people expect all swans to be white because that's the color experience tells them they should be. A black swan is, quite simply, a surprise, though there are many.

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The insurance underwriting equivalent of V@R is PML – Probable Maximum Loss. While not necessarily built to the same exacting quant standards, actuaries and underwriters apply PML to establish portfolio loss exposures in stress periods.

Events of the past eight quarters raise a question for risk managers. When should they put their algorithm models aside and make decisions based more on subjective degrees of belief about "an ALWAYS uncertain future", as Peter L. Bernstein phased it in "Against the Gods?"

I touched on this very subject in last year's President's report, when I discussed risk perspective and its impact on FM's operations at length.

Conventional underwriting is essentially a look in the rearview mirror. The underlying assumption is that individual risks and, by extension, whole market sectors with low historical losses will continue to have low losses in the future. Operating under this premise, the insurance industry moves through cycles that drive premiums, profits and – ultimately – capital down, until a bottom is hit and the process reverses.

The real problem with this conventional approach is that is pro-cyclical. It practically ensures an outcome in which markets are least prepared for storms on the days they unpredictably occur. For banking institutions, it means that loan loss reserves are at their lowest when needed most. For insurers, it means that the redundancy (excess) in loss and loss expense reserves is depleted. In both cases, it results in hits to capital.

A look-back at the state of the 1984 commercial insurance market provides a perfect example. Just prior to the banking crisis, insurers were providing 3-year prepaid D&O contracts to community banks at annual premium expense of $2,000 to $3,000 per million of coverage -- including protection against regulatory claims. Just six quarters later, many community banks found themselves uninsurable, and those that didn't were forced to pay hefty sums for restricted coverage and reduced limits. This "Black Swan" circumstance created a need for and led directly to First Monetary's founding.

It's been many years since we survived that crisis, but the market apparently learned little from the experience. D&O underwriters have again loosened their standards and reduced rates. D&O premiums, reserves and capital have predictably fallen in a straight line as a result, to a point where many are now asking whether the market is poised for another reversal. From our perspective, the short answer is -- not yet. Our assessment at year-end 2008 put the chance of a hard market reemergence at 60%. Mid-way through 2009, the market shows no immediate sign of change. D&O coverage remains readily available for community banks, but the underlying pressure for change is still there.

Fortunately for FM, we've always taken the "Black Swan", 1% risk perspective in managing this company. It is reflected in a founding philosophy that states "FM will complement, and not compete with the commercial market". We shed risk when price/exposure ratios are favorable and increase it only when profitable to do so. Whether or not the market changes direction, we're prepared. The remainder of this report details FM's 2008 underwriting, investment, and strategic risk performance and explains why.

Underwriting Risk

Underwriting risk describes situations in which insurance prices don't cover the corresponding level of insurance claims. FM manages this risk by monitoring trends and statistics, while consistently applying outlier possibilities.

D&O

When commercial providers rushed to cut d&o rates between 2003 and 2007, we trimmed company loss exposures and held premiums steady. Overwhelmingly, we've been able to substantially increase overall protection for members in combination with primary commercial cover, holding the line or reducing aggregate costs in the process. The path we've chosen has been vindicated in recent quarters, and continues to pay handsome dividends vis-à-vis very strong working relationships with Lloyd's of London.

Our discussion to this point has centered on perspective. Here's some pertinent reference information that is currently shaping ours:

- FM isn't a D&O market-maker, but has proven adept at compensating for market change. At present, FM – Monetary System effectively operates as both an insurer and "risk group" -- negotiating broad, low-priced contracts with commercial insurers when advantageous, and assuming risk in cases where coverage is not available, such as CRA Lending Discrimination coverage.

- FM has pursued a strategy that quickly and dramatically reduced its primary loss exposures. At this time, we have effectively eliminated the exposure to loss from primary D&O claims. The company's very safe profile, low maintenance costs and ability to render risk management consulting and support services through the Monetary System, carries member benefits and preserves all business continuance options while the market remains fluid.

- FM altered its underwriting practices to reduce its CAR (capital at risk). We continue to maintain a 10% capital at risk maximum – net of reinsurance – on all primary d&o policies and a 25% capital at risk maximum – net of reinsurance – on all secondary "wrap-around" contracts.

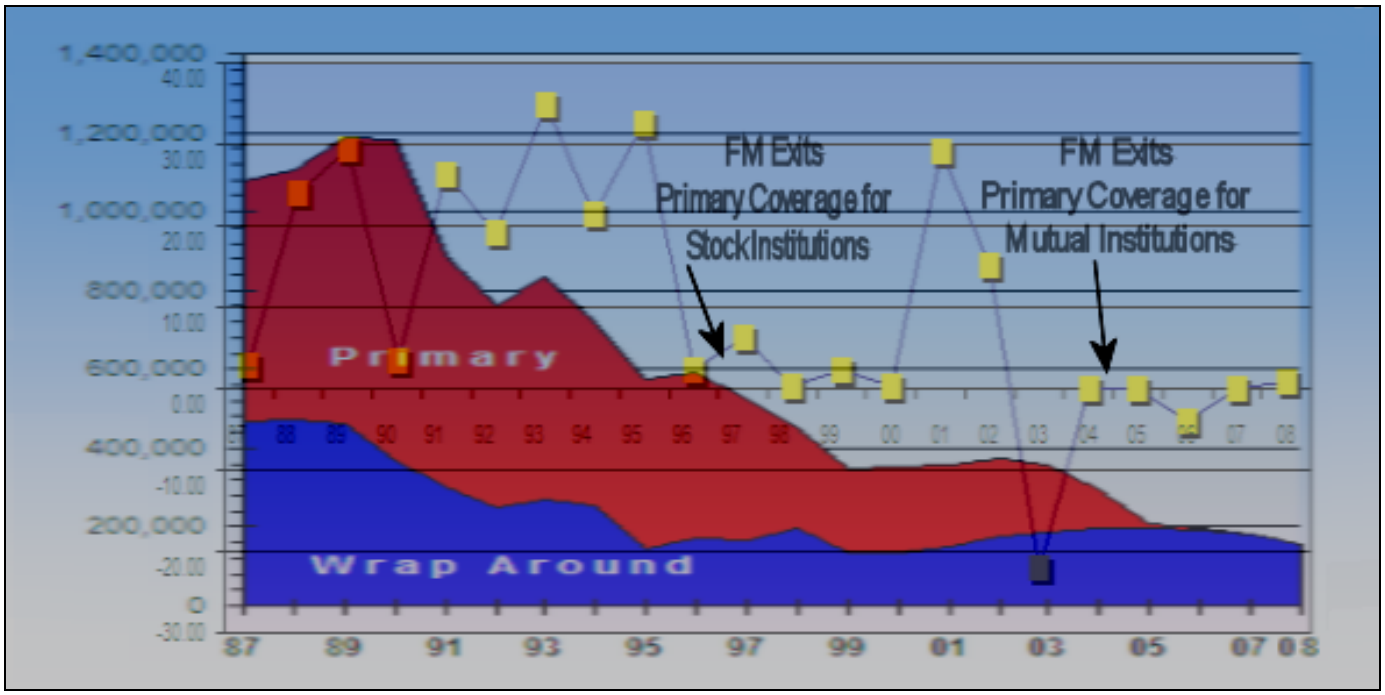
- This combination of actions has produced loss ratios of less than 1% for the past 11 years on FM's D&O line of business.

- For long-term planning, FM needs to ensure that optimal levels of underlying D&O coverage being maintained as a condition of underwriting. These underlying levels have direct bearing on FM's reinsurance costs. Reduced limits on renewal contracts are a cause of concern for us.

- FM's underwriting strategy is made possible through the support of Lloyds of London and the reinsurance treaty it extends us.

The reinsurance program provides: 1) Loss experience stabilization 2) Large limit capacity and 3) Limited catastrophe protection. Given the recent state of the D&O market and financial crisis, FM is delighted that Lloyd's again extended favorable D&O treaty terms in 2009. A significant change to or termination of the current arrangement would force significant changes in FM's operation.

The following chart presents a visual representation of the company's GWP (gross written premiums), incurred loss and loss expenses on the D&O line since inception. You will note that loss ratio chart (yellow boxes) has fallen dramatically from 1996, corresponding with decreases in the exposure to loss from primary d&o contracts as represented by the premiums written.



FM has been a grateful beneficiary of the commercial market's decision to continue providing broad-based coverage at low cost. While the need to maintain a company like this one in such an environment can be questioned, there is certainly a benefit in doing so from a STRATEGIC risk perspective. This will be covered in a later section.

EPLI

Changes in risk perspective apply across lines of coverage. You'll note from the financial report that FM's Employment Practices Liability Insurance (EPLI) product is no longer producing revenue. The reason again involves risk verses return. In response to a completely different shareholder need, FM implemented an EPLI program more than a decade ago. At its launching, minimum premiums charged by the commercial market for comparable coverage were judged excessive by many community institutions.

Policy issuance also mandated the adoption of formal employment manuals as a prerequisite for coverage. Many members lacked the capacity to produce these documents internally, and compliance would have required substantial investments of time and money to produce them from scratch or externally. In answer to these problems, FM created a 100% reinsured program in partnership with Lloyds of London. Its unique structure permitted FM to earn a 15% ceding fee for the work product, while assuming virtually no incremental risk. The insurance product was packaged with template employment manuals members could adopt, eliminating individual development costs and speeding rollout. They are still utilized, in updated form, by many today.

FM's EPLI program was an instant hit, and that made the product a target for imitation. Over time, it was mirrored in the commercial market, where size advantages eventually reduced delivery costs to levels below FM's. When the only way to stay competitive involved reinsurance expense reduction and unacceptable risk assumption, FM exited the line. From an underwriting risk perspective, the additional income did not warrant the additional exposure.

This EPLI venture did serve as a reminder of the value an alternative entity like FM can provide when commercial markets turn "hostile". FM retains the capability to restart the program should conditions warrant. With commercial market result presently deteriorating, we're watching for emerging opportunities.

PMI

FM was the first Community bank entity (1999) to offer a PMI program to Members, and to date has been the only organization to offer Members a choice of carriers -- MGIC and Radian. From an underwriting risk perspective, our PMI has performed very well, despite some recent pressures brought on by a collapse of the mortgage market.

In 2005, RADIAN terminated its SONYMA mortgage pool program. This decision, coupled with the acquisition of a large PMI producing Member, depressed revenue growth on the Radian component. Overall PMI revenues continued to climb.

In the fourth quarter of 2008, RADIAN went on to announce the elimination of all excess of loss reinsurance treaties. This action directly restricted the placement of new business in the program. FM is presently exploring options in discussions with the company.

MGIC also announced the elimination of their excess of loss treaties in the fourth quarter. This action required a change in the original 2001 treaty that MGIC maintained with FM.

MGIC's move is an effort to protect itself from high losses the continuing dislocation in residential housing and related mortgage lending has brought on. The company has raised $840 million in capital through securities sales, changed its underwriting guidelines, and raised premiums.

Per terms of the now terminated excess of loss 4.5/5/25% treaty, MGIC assumed the first 4.5% of all losses, with FM providing protection for the next 5% of losses. In return for this loss sharing arrangement, FM received 25% of the GWP.

Loans reinsured prior to 31 December 2008 will run off under the terms of the previous treaty and renewal income will be added to the trust account in accordance with those provisions.

FM's Board approved a new quota share treaty for 2009; it provides that MGIC transfer 25% of the premium collected in exchange for 25% loss protection on each loan. FM's PMI risk profile is expected to increase slightly in the early going. Aggregate exposures to loss will be assessed and evaluated on a continuing basis. Revenue streams should stay consistent with past results. MGIC is providing separate reports for this book.

FM will feel a minor effect from MGIC's treaty cancellation in 2009, but the changes are manageable. It's important to note that cash withdrawals from the trust will continue to be available to First Monetary.

Investment Risk

Various risks are associated with investment management. They involve performance, returns, liquidity and portfolio structure. Investment risks substantially impact the asset side of FM's balance sheet and directly effect FM's overall liquidity. Proper management is required to prevent the company from becoming over-indebted or insolvent.

Consistent with our conservative approach to underwriting, FM has remained conservative in dealing with investment risk. In short, we seek to deal with as little of it as possible.

First Monetary assigns high importance to the liquidity, security and marketability of its assets. Management long ago implemented an investment policy that directs all available FM funds into CDs. These are parceled out on an exclusive basis to members in bundles not exceeding $100,000. Funds available for investment are determined by FM's capital and surplus, and are adjusted for timeline expectations on those occasions when incurred losses need to be paid.

FM maintains a separate trust for the MGIC reinsurance program. Investments in this program are directed into low-risk Federal Government Obligation Fund.

As far as performance is concerned, interest rates on the CD program declined from 2007 to 2008, and yields are expected to decrease further in 2009. Interest rates and returns on the Trust program are on a parallel track. The loss of interest income brought about by the declines has reduced FM's profitability for the reporting period.

Strategic Risk

The capstone concept in this discussion is strategic risk. Everything previously mentioned feeds into an overall and longstanding desire to ensure that First Monetary survives and CAN respond when markets change and deficiencies arise in commercial markets.

Success in that endeavor helps ensure that desirable coverage can always be purchased, that a dividend potential always exists, that group purchasing and negotiating power can always be effectively leveraged and that counseling always remains available for members who need assistance with their own risk management practices.

In a market that has remained stubbornly competitive, scaling back FM's risk exposures and expenses to an absolute minimum has enabled us to meet our strategic risk goal of "being here". We may not be the biggest kid on the block, but no one has been able to kick us out of the neighborhood.

Maintenance expenses and time requirements associated with full-service administration have given rise to the need for services that compensate for reduced administrative fees. Recent ventures have been concentrated on providing internet-related services that promote bank security and risk management capabilities.

The Monetary System has completed the rollout of a secure communications and storage service with e-Board.com. It is now deployed at a number of member banks and utilized by a growing number of managers, regulators and directors.

Commercial insurance companies simply meet the risk financing needs of customers. FM, through its association with Rex Wyon * Monetary System, offers a valuable package of coverage and services worth one to five times the amount of paid-in premiums. Beyond insurance, this package delivers many management support tools and subscriptions:

- E-Board Silver Service (http://e-board.com) Value ~ $3,500 to $10,000
- American Banker Online: Value ~ $300 - $1,800
- Online access to Mortgage Thrift News: Value ~ $300 to $1,800
- Online access to Credit Union Journal: Value ~ $300 - $1,200
- Shareholders Meeting Expense Reimbursement: Value ~ $400
- INTERmoNETary Web Services: Value ~ $1,000 to $5,000
- D&O CRA Liability Insurance: Value ~ $2,500 to $3,500
- Employment handbook/policy templates: Value ~ $250 to $3,500

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President's Report

Risk Management: The Black Swan

Summation

Francis J. Shashaty
President & CEO

Despite worldwide financial turmoil, FM turned in a very solid 2008 performance. The only tangible impact of the market mayhem surrounding us was an earnings reduction, but we still managed to turn in a fourth consecutive year of profits and pay out a $15,000 member dividend. Specifics are fully outlined in the financial and profitability reports accompanying this presentation.

Returning one final time to the "perspective" debate, our outlook for 2009 is one of cautious optimism. Historic rate reductions at the Federal level will continue to pressure earnings, and the possibility exists that we will see some D&O and PMI claims activity. Assuming that both remain within projected levels, however, our new PMI agreement and IRS tax-exempt status will permit the company to continue in its mission of protecting decision-makers at community banks. .

FM's positive prognosis reflects an ongoing and continuing commitment to operational efficiency and transparency in governance. Our solid underwriting performance is directly tied to the efficient management of our shareholder institutions. Congratulations all.

On a personal note, I'd like to thank you all for keeping faith through trying times. It was a pleasure to work with Jim Roy as Chairman, and welcome David Hunsicker to the Chair. I trust you're all looking forward to our 25th anniversary celebration as much as I am.

Frank J. Shashaty
President & CEO
First Monetary Mutual Limited