First Monetary Mutual Limited

Protecting the Decision Makers at Community Banks
Chartered 1986 - Hamilton, Bermuda

Twenty-Seventh Annual Shareholders Meeting
Monday, 11th June 2012

The Fairmont Southampton Princess Hotel
Southampton, Bermuda

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

"We are in uncharted waters. We do not know where the rocks and shoals lie."

This "lost-at-sea" summation was voiced at the fifth-annual Risks International conference in Paris – where unprecedented market uncertainty in the investment environment was the central topic of discussion.

Port-of-Call – Bermuda. Welcome home for the twenty-seventh time!

Last year this time, we built our program around a "Play it again" theme that highlighted commonalities in the situation that existed at the time of FM's founding and present day situation. We revisited our origins and painted some alternative scenarios for an unsettled future affecting both this company and community bankers in general. Not much has changed since that last gathering, First Monetary and its shareholders have been pushed along with the currents.

Francis J. Shashaty
President & CEO

We're now floating around in a somewhat stagnant economic pool that's still prone to develop an occasional whirlpool. From a captain's perspective, sea conditions still look remarkably similar to 1986. Some community banks in tough straits are finding safe insurance harbors closed to them. Several hundred institutions have been sucked down since problems in the real estate market first surfaced in 2008. Many more continue to face headwinds of litigation and prospective litigation from multiple stakeholders. Over 900 institutions remain on the government's troubled bank list foundering in fog, still in danger of grounding, perhaps worse.

We're at the convergence point of three rogue waves – one structural, one regulatory, and one economic.

- The overall fleet is smaller in number than thirty years ago. Unlike then, some larger "vessels" are throwing wakes and damaging the smaller ships.

- A regulatory swell is overloading small financial and insurance "vessels" with cargo, and raising the compliance and audit cost water line.

- The sluggish economy and challenging real estate conditions are aggravating the swells swamping small boats who were long the mainstay of the FM fleet. Too big to fail mentalities directed bailout capital into the insurance market, creating a competitive swell with insurance costs remaining static or rising only nominally for A or B-rated institutions.

As a group, we remain at sea searching for the rising tide that lifts all boats. As noted in our Chairman's report, many veteran FM Admirals are retiring their flags. For many of you, this is the first cruise of your new commands. It's a big ocean, and we'll be looking to the new ideas you bring aboard to steer us to calm waters. At present, we're holding steady on the bearing established in our business plan and keeping steam in FM's boilers while you gain your sea legs and we get a firmer sense of the next tide's direction.

2011 Operational Highlights

Here's our ship's status at the current change of watch:

- FM will pay its fifth consecutive dividend and post its seventh consecutive profitable year;

- A premium stabilization fund remains in place five full years after what was anticipated to be its exhaustion date. The current balance exceeds $500,000 and is available for use as either an offset to higher than expected losses or a ready reserve for windup expenses;

- Operating costs have been effectively capped by PROPHET plan actions introduced in 2004. While there has been some annual variation, overall figures have been reduced approximately $120,000 since plan introduction;

- FM Membership has been static and is presently open to only C or better rated institutions;

- **D&O Income:** Aggregate D&O Income decreased $5,000 to $170,198 for the reporting period. Most Members continue to purchase high primary commercial D&O limits, a natural outcome of the continued softness in the D&O insurance rates charged for well rated institutions. Although the increased primary limits reduce the cost of FM's secondary contracts, FM's exposure to primary loss is also diminished significantly offsetting the minor income reduction.

- **PMI Income:** PMI income tallied $202,834 in 2011 after returning $205,791 in 2010. The line appears to have stabilized at this level and is expected to remain flat over the new forecast period;

- **Investment Income:** Low investment yields continue to hamper earnings. Viewed alone over the past 16 quarters, it's apparent that the decline in investment income is a principle contributor to reduced profitability. Were 2011 interest rates on par with 2007, company profit would exceed $65,000.

2011 Operational Highlights

- **D&O Claim Frequency / Severity:** Claims frequency increased significantly in 2011 with eight new claims reported. At this point, there is no expectation that FM or Lloyds will experience an actual loss as a result this activity. After allocating all loss reserve activity (puts and takes), financial movement in the loss and loss expense reserve account amount to -$7,500 for the review period. This development supports the conservative reserving practices of the past and current underwriting/pricing models.

- **Underwriting/Service Fees:** Rex Wyon Services maintained its voluntary fee reduction during 2011 and took a further one-time reduction of $50,000 to ensure positive financial results. Our third-party audit, actuarial and legal expenses remained flat, and no change is anticipated through 2012;

- **Director's Reimbursement Expenses:** Expense reimbursements have been restricted in accordance with our approved business plan. Following the special 25th anniversary meeting, they were reset to the 2009 level of $400;

- **Member Meeting Expenses:** Quality risk management sessions have been a hallmark of FM membership, and have been routinely employed to introduce both innovative risk management techniques and technology-based support systems to the general membership. The latter facet has permitted faraway support personnel, most notably Lloyd's of London, to indirectly "participate" in our meetings, gain comfort in our relationships, keep up on management reporting and avoid costly expenses that might otherwise negatively influence contract decisions or be passed along to FM's bottom line. At the present time, FM is adhering to a two-meeting schedule, comprised of the Shareholders meeting in June, and the year-end board meeting and dinner in December. Approximately $123,000 was expensed for meetings in 2011, a $20,000 reduction from the previous period. It's an unavoidable fact that meeting expenses represent the largest year-on-year item in our budget. As such, it continues to be closely monitored and tweaked where necessary.

Strategic Approach and Evolution

FM's level of risk undertaking and ongoing commitment to assuring resources remain in place to implement agreed upon strategy are key elements that factor into management discussions and Board decisions. We've developed and evolved several strategies to deal with the shifting tides confronted.

The "Wraparound" Product Strategy

In 1986, we configured FM to help banks that could not obtain adequate coverage or key component protection such as security against regulatory claims when commercial insurers were unwilling or unable to provide same.

The "Product Halo" Strategy

1995 saw a major market cycle adjustment and a return of commercial insurers in aggressive force. Premiums fell fast and far in the years that followed. Had FM blithely followed commercial market pricing in lockstep while maintaining broad limits and expanding coverage, you most certainly wouldn't be reading this report.

Recognizing that our small company couldn't hope to challenge the majors head-to-head, we implemented what came to be referred to a "Product Halo" strategy. We shifted emphasis away from the marketing and sale of D&O insurance and added an ancillary technology service and support arm. The new INTERmoNETary System offered IT education, web hosting and implementation services that obviated the need for high-priced consultants. This was folded into the matrix as a standard benefit of FM membership and permitted us to compete in the market on a basis other than price.

The "Product Market Growth" Strategy

In 1999, First Monetary recognized and identified emerging opportunities in the private mortgage insurance arena. We secured new treaties and ushered in a PMI operation, setting up what was the first dual-choice program available in the market. The appeal of this program extended beyond New York, and ultimately led to new relationships with community bankers in Pennsylvania.

The "Dynamic Stasis" Strategy

By 2004, the internet had become a well established commodity and electronic payment providers moved into banking services. The banking industry became extremely profitable, and D&O insurers were tripping over themselves to insure financial institutions on terms our conservative company wouldn't touch. A new dynamic stasis strategy was developed and implemented. It has guided all PROPHET business plans since. We progressively moved to conserve resources and aggressively pursue risk minimization. We moved into second policy positions on all coverages, dramatically reducing treaty placement costs. We pared meeting and marketing expenses dramatically. These actions permitted FM to return to profitability and dividend paying status while maintaining an ability to react to any potential reversal in the competitive market.

Risk Management Summation

Irrespective of tide flows or tacks assumed while sailing under these various strategies, FM has consistently maintained a conservative risk profile: First Monetary ("FM") is a non-assessable mutual insurance company chartered in Bermuda. Its strategic plan is executed in accordance with Board approved policies, practices and procedures and based upon a balance sheet risk management approach. FM accordingly places significant emphasis on management of the following risks:

Asset Quality & Liquidity

A primary source of FM income is investment earnings on available funds. Amounts available are directly determined by capital and surplus and the interval within which incurred losses are paid.

Given the high importance our company assigns to liquidity, security and marketability of assets, FM has routinely held to very conservative investment policies that rely exclusively on returns from certificates of deposits deposited with FM members or US Government backed securities. All individual certificate values carry limits less than FDIC guarantees.

The level of investment returns remains depressed given a perpetuation of the low interest environment.

Quality & Appropriateness of Our Reinsurance Program

FM has continuously underwritten Director and Officer Liability risks of the group on a direct basis for twenty-seven years. The program is reinsured by Lloyds of London, an A rated reinsurer. Our treaty provides:

1. Loss experience stabilization
2. Large loss capacity
3. Limited catastrophe protection (automatic reinstatements)

Lloyds of London has renewed FM's D&O treaty for 2012/13 without an increase in reinsurance rates or reduction in coverage limits or restriction on terms.

Adequacy of Loss Reserves

The proportion of loss reserves to capital and surplus – reserve leverage ratio - provides important insights into an insurer's health. A proportion of 3:1 or more is used by many property/casualty captives. FM's regulator, The Bermuda Monetary Authority ("BMA") permits ratios as high as 10:1.

FM considers the Loss Reserve Ratio a key risk management component. Insufficient reserves are the leading cause of insurer insolvency. For long-tailed lines like D&O, estimating loss reserves accurately is often difficult and imprecise. FM believes it wise to build in a small margin of safety in the event claim reserves prove less than required to respond in a specific incident.

Adequacy of Loss Reserves (Continued)

Here's why. A reserve leverage ratio of 2:1 could give rise to a situation where reserves underfunded by just 5% would result in a surplus overstated by 10%. Under this scenario, any surplus correction would impair the company's condition.

FM closely monitors its reserve leverage. A ratio under 1:0 is considered conservative, while a ratio above 2:1 would call for extra reserve attention.

- **FM's standing policy is to maintain a loss reserve ratio that does not exceed 2:1**
- **FM's 2011 loss reserve ratio was less than 1:1**

Capital @Risk (CAR) - Capital Formation and Adequacy

FM has paid particular attention to the management of its capital at risk (C@R). Oversight of our solvency and retention ratios are key risk management components.

Solvency ratio: This ratio represents the maximum level of premiums FM is permitted to write on a net basis compared to its capital and surplus position. In Bermuda, a 5:1 ratio is permitted. That ratio would allow FM to write up to $6MM based on current assets.

While a 5:1 ratio is permitted by regulation, FM voluntarily adheres to a more conservative 2:1 maximum limit. FM's capital and surplus are provided by members that make a single reserve premium contribution equal to 50% of the Member's first year annual premium for a $600,000 policy limit - generally between $2,500 and $6,000. Accordingly, FM is able to maintain a minimum 2:1 solvency ratio as new members join the company.

- **FM's 2011 solvency ratio is less than 1:1.**

Retention ratio: This ratio represents the amount of per-occurrence risk retained net by FM compared to its capital and surplus position. It has been FM's policy to:

1. Maintain a 10% capital at risk maximum, net of reinsurance, on all primary D&O policies
2. Maintain a 25% capital at risk maximum, net of reinsurance, on all secondary "wrap-around" contracts.

- **Both ratios were maintained in 2011**

D&O Insurance Underwriting Cycle

- **Commercial Insurance: Pro-Cyclical Risk Management Strategy**

  From a logical and objective business standpoint, the inherent problem with the conventional commercial market insurance pricing is that it moves *pro-cyclically*. When bank profits are high, reserves for loan loss fall to their lowest points. During these periods, D&O, FDIC insurance and other risk-based expenses trend low.

  On the upside, this "temporary solution" is greatly beneficial for banks. The problem occurs in downturn situations, when institutions confront a painful "double whammy". At the very same time they must add reserves, they face a situation where:

  - Insurance markets close at the time they are MOST needed
  - Insurance costs rise at a time they are least affordable

- **First Monetary: Counter-Cyclical Management Strategy**

  In stark contrast, FM has pursued a contrarian approach to management of the underwriting cycle. Our method works best in stormy economic seas, when risks of loss are most tangible. It offers a peace-of-mind that comes from knowing you'll continue to have access to insurance at affordable rates.

  FM's counter-cyclical approach perfectly complements the central mission of "Protecting Decision-makers (Directors, Trustees and Officers) at Community Banks". First Monetary's tack promotes stability and predictability in up and down markets alike. During stressful periods, like those we currently find ourselves in, membership in this organization brings concrete benefits in the form of:

  - Continued coverage availability
  - Stable pricing and
  - Potential profits that offset premium costs

  FM's D&O Program doesn't attempt to catch the perfect wave. That's too unpredictable. What we've done is build up a solid, reliable, long-term program that can ride out whatever rises up before us.

The Near Horizon

First Monetary's profits remain under tremendous pressure from the combination of rock-bottom interest rates and a lack of demand for D&O coverage from stronger banks.

What has become apparent is that a central part of every regulatory exam now includes a focus on strategy and risk management. Accordingly, Board members and management must be ever more watchful for icebergs and anticipate every compass point they may come from.

First Monetary's focus on risk management always has and will remain forward-oriented. We very consciously afford healthy respect to the possibility of haphazard, "black swan" events, and even provision for it. More important to FM's longevity and success, however, has been our ongoing and conscious attention to the black swan's more easily detectable counterparts, something Nouriel Roubini refers to as "white swans". These are potential crises we DO have the power to anticipate on the radar screen, batten down the hatches for and steer around. The simple reality of the financial crisis enveloping today's banking industry is that there was really nothing new, random or particularly unique about it. It was all very much the predictable outcome of financial policy decisions that ultimately led to asset bubbles, over-leveraging and vulnerabilities that we're all well acquainted with now. That knowledge and experience will put us out in front of the next strong tide.

With no immediate threats to navigation along our route, FM plans to continue steaming along its pre-established route for the next leg of our voyage. While making knots, we'll continue scanning the sea for signs of changes and sounding foghorns that help all hands improve Compliance Management Systems. Planned enhancements for e-Board 4.0 will strengthen that capacity.

The Next Twelve Quarters

First Monetary's dynamic stasis plan will permit First Monetary to promptly execute some precise point-to-point navigation in the twelve quarters ahead. Prudent and timely course corrections have kept us out in front of the economic storm fronts that have roiled things and stuck around since 2008. What lies over the horizon remains to be seen, and our plot line may shift when our new Director's are comfortable in the bridge chairs.

FM will continue to cut waves as long as long as there remains need for our cargo and fire in our boilers. The continuing pattern of industry turbulence indicates that the former is unlikely to subside before 2015, and there's plenty of fuel in our bunkers to sustain us along the way. We'll watch for opportunities as we sail, and set longer-range plans once we determine what the new tide brings with it.

Thank you all for remaining the anchors of our company's continued prosperity.

Frank J. Shashaty, CPCU, President & CEO
First Monetary Mutual Limited