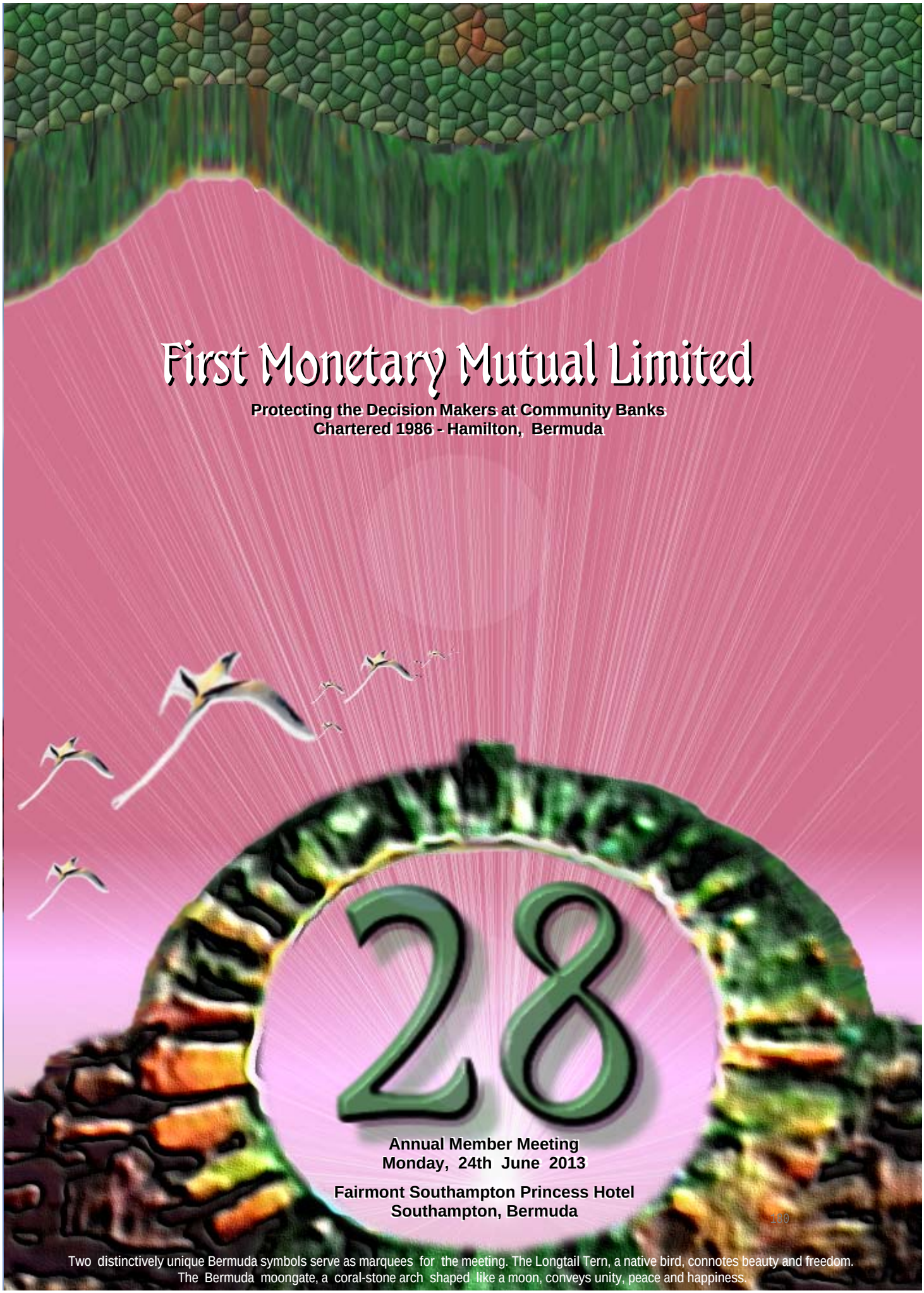
First Monetary Mutual Limited

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



Annual Member Meeting
Monday, 24th June 2013

Fairmont Southampton Princess Hotel
Southampton, Bermuda

Two distinctively unique Bermuda symbols serve as marquees for the meeting. The Longtail Tern, a native bird, connotes beauty and freedom. The Bermuda moongate, a coral-stone arch shaped like a moon, conveys unity, peace and happiness.

Agenda Item Five [A]

President's Report
Changing Tides

The Changing Tides

If you leave your mark on the beach,
Make sure it's one that stands against time,
A mark that can be viewed with pride,
Not one to be lost in the changing tides.

Poet Randall Beers

Last year this time, we built our conference around a "Changing Tides" theme. We raised red warning flags about the worrisome confluence of three rogue waves – one swell rising from a structural change in our industry, one cresting from the deluge of new financial regulation and one surging to peak on heaving torrents of economic and competitive developments. In short, we traced their base and rise to the following:

- The structural wave – Many small community banks have been swamped and gone under. Our fleet is much smaller than it was thirty years ago, and some of the larger bank "vessels" we find ourselves trailing are casting damaging wakes our way.

- The regulatory wave – We've been weighed down and overloaded with a shifting cargo of regulation that is raising compliance and audit costs above the water line.

- The economic and competitive wave --- A still sluggish economy and real estate market isn't strong enough to blunt the gush of challenges we confront as a group. The high seas rescue effort associated with the too big to fail mentality continues to direct flotation capital to the insurance market. The rising tide of threats hasn't been reflected in rising costs of insurance premiums.

Our portent proved prescient, but the changing tide we were expecting turned out to be a rip current, and it arrived ahead of our anticipated schedule. We find ourselves caught between the heaves and rollers. Low interest rates continue to hurt our investment portfolio performance. Consolidation of the membership base is impacting gross premium receipts. The competitive attractiveness of our captive is artificially prevented from becoming apparent. The Consumer Financial Protection Bureau (CFPB) action against the PMI industry was a virtual tsunami with wide-ranging consequences for our ventures with MGIC and Radian.

We're forced to batten down the hatches, but First Monetary is no stranger to stormy seas. The keel under our feet is solid, and once again we're in no immediate danger of foundering. In point of fact, we rode the initial waves of the changing tide high and dry.

What has rapidly become apparent though is that the dynamic stasis business model that enabled us ride out the first set of breakers will have to be altered if we are to get past succeeding sets. A balanced approach that merges consolidation, product redefinition and expense reduction in some combination are certainly called for. We'll be actively seeking your input as we shape plans between now and our year-end gathering.

From this sheltered Bermuda cove, we'll review our 2012 performance, survey the seascape and begin to lay out our options for getting out in front of the chop. Greetings and welcome home for the twenty-eighth time!

Agenda Item Five [A]
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2012 Operational Highlights

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

- FM will pay its sixth consecutive dividend and post its eighth 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;

- Conservative underwriting continues as Membership is presently open to only C or better rated institutions;

- **D&O Income:** Aggregate D&O Income decreased $20,000 to $150,394 for the reporting period principally due to Member mergers. 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 income reduction;

- **PMI Income:** PMI income tallied $192,430 in 2012 after returning $202,834 in 2011. The termination of the MGIC & Radian PMI reinsurance treaties means earnings from this line will decrease and end in the next ten years;

- **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 2012 interest rates on par with 2007, company profit would exceed $65,000;

2012 Operational Highlights

- **D&O Claim Frequency / Severity:** Claims frequency moderated modestly during the period with seven 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 -$10,000 for the review period. This development vindicates the conservative reserving practices of the past and current underwriting/pricing models;

- **Underwriting/Service Fees:** Rex Wyon Services maintained its voluntary fee reduction during 2012 by reducing fees $72,675 over the contracted agreement. Third-party audit, actuarial and legal expenses remained flat, and no change is anticipated through 2013;

- **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 $113,552 was expensed for meetings in 2012, a $10,000 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 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 the 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 2013/14 without an increase in reinsurance rates or reduction in coverage limits or restriction on terms.

Liquidity

During the year ended December 31, 2012, the Company's cash flows from maturity of certificates of deposit, Directors' and Officers' Liability insurance premiums, and interest earned were sufficient to discharge its obligations, and meet statutory liquidity requirements. However, this was achieved with the support of Rex Wyon Services, who agreed to reduce their fees for 2011 and 2012 by a total of approximately $144,000.

The decision to place the MGIC treaty into run-off from 2013 will have a negative impact on the Company's operating cash flows for the foreseeable future, as MGIC PMI premium receipts will continue to be placed with the Trust account, but the Company will not receive any distributions from the Trust.

The impact on the Company's actual cash flows will not be reflected in its Statutory Return, Declaration of Statutory Ratios, as for statutory purposes, the Trust account is considered a liquid asset.

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.

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 1:1 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 2012 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 $500,000 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 2012 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 2012**

Agenda Item Five [A]

President's Report
Changing Tides

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.

PMI's Ebb Tide

On March 8, 2013, the MGIC agreement was terminated and put into run-off. This means that FM's liability under PMI policies that became effective prior to cancellation the treaty remain, but FM will continue to earn reinsurance income on in-force policies. The run-off period will last ten years. The government's arbitrary action means that this well-run, successful program has reached its high water mark and the tidal flow of company income will progressively swing to ebb in the years to come.

This settlement has both short and long-term implications:

- **Short-term Implications**

  During the year ended December 31, 2012, the Company's cash flows from maturing certificates of deposit, Directors' and Officers' Liability insurance premiums and earned interest were sufficient to discharge obligations and meet statutory liquidity requirements. Rex Wyon Services facilitated this by voluntarily agreeing to reduce fees for the 2011 and 2012 accounting periods by a total of approximately $144,000.

  With the MGIC treaty placed into run-off in 2013, there will be a negative impact on the Company's cash flows for the foreseeable future, MGIC PMI premium receipts will continue to be placed into the Trust account, but the Company will not receive distributions from the Trust.

  By way of illustration, the Company's cash flow from Trust withdrawals totaled approximately $77,000 for the years 2011 and 2012, averaging $38,500. Rex Wyon Services' fee reductions during the period averaged $72,000, but actual cash settlements for the two years totaled $53,000, therefore revising the average to $26,500.

  Consequently, the likely annualized impact on cash flows, assuming only reinstatement and settlement of Rex Wyon Services fees, will be a reduction in cash flows of approximately $132,000 per annum. Total certificates remaining on deposit at December 31, 2012 were $605,000, of which $175,000 was encumbered.

  There are, of course, other factors to consider, and the scenario presented above is based on current membership, a worst case example of outcomes, and projections of income and expenditure. For example, meeting expenses of approximately $120,000 per annum represent a significant part of total Company cash outlays -- the most elastic we incur.

  We have confirmation that the impact on the Company's actual cash flows will not be reflected in its Statutory Return or Declaration of Statutory Ratios, as the Trust account is considered a liquid asset for statutory purposes.

- **Longer-term Implications**

  Termination of the MGIC PMI reinsurance treaty will mean a gradual decline in FM's income over time, ending completely at the end of ten years.

In recognition of these realities, it falls to us to ensure we address our immediate cash flow threat while a longer-term safe harbor strategy is developed.

Looking Forward

Drawing upon the man against nature metaphor, we're powerless to fight or alter tides. One must flow with them. As long as we have power and rudder, we can control our drift. That's the tack we have successfully taken with First Monetary's dynamic stasis strategy, and the course we've charted with it has permitted us to safely navigate hazardous waters from 2004 through 2012. We just need a new one.

FM is actively exploring alternatives that can replace the loss of PMI revenue. We've been scanning the horizon and believe we have identified a viable product opportunity First Monetary can successfully pursue by enhancing regulatory protection that FM affords. Restrictions on a financial institution's ability to pay for this type of coverage creates a niche our company's product is capable of filling. With demand for the protection stemming from individual executives as opposed to institutions at large, we can broaden our market and increase our ability to reach inside executives and outside directors on a direct basis, and start conversations with institutions that heretofore haven't had a chance to get started. If support for the idea exists, a rollout framework can put in place by year-end for interested Members. Alternatively, FM will offer choices that permit Members to avoid any further obligation or risk.

We'll begin to develop these ideas in the course of presentations and conversations at this shareholders meeting, and we'll continue them in earnest through our December meeting. We want everyone onboard in formulating the sail plan for the next eight quarters -- and not just for ballast. You are and will remain anchors of our company's continued prosperity.

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