



Agenda Item Five [A] President's Report Riding the Changing Tide



"Behold, seven years of great abundance are coming in all the land of Egypt; and after them seven years of famine will come, and all the abundance will be forgotten in the land of Egypt, and the famine will ravage the land.

Genesis 41

How about that? An Old Testament example of risk management drawn from the Bible. This one speaks to Joseph's anticipation of a great drought and warning to prepare for the future.

Welcome Home Members and Guests!

I begin by sharing this biblical feast and famine passage I first read in the 1950's.

When ancient Pharaoh was delivered an incomprehensible dream from God, he summoned Joseph, who had come to be as an interpreter by a trusted advisor who had formerly been imprisoned with him. Joseph warned Pharaoh that his dream foretold seven years of bounty followed by seven years of terrible shortage. Joseph was exalted as Regent of Egypt and wisely charged with overseeing food storage programs that would help his nation survive these foretold crop failures. It did.

I found this story fascinating for reasons unknown at the time. It taught me an important life lesson – that one could and should successfully plan for calamity. I recall asking grownups whether they were following this sage advice in their day-to-day lives and questioned why many appeared ambivalent to its merits.

Without knowing it at the time, I had developed a youthful interest in risk management. Through education and professional training, I came -- over time -- to understand that changes in circumstances were inevitable, but putting timetables to them was far more difficult.

First Monetary is certainly in the midst of one now. Last year, we built our conference on a "Changing Tides" theme. We spoke to the confluence of three rogue waves – structural change in our industry, a deluge of new financial regulation and a torrent of economic and competitive pressures. This year, we want to tell you how we are riding that changing tide. When next we meet, I would hope our talk will be focused on "Rising Tides."

Akin to my biblical reference, we have many times noted that the average life for a successful insurance captive is a seven-year pattern of growth followed by decline. Without creative and concerted interim efforts to move things in new directions, the cycle ends in oblivion.

It is a testament to our joint commitment and flexibility that FM has not met a similar fate. FM turns 29 this year. Our company has survived and transitioned through four seven-year cycles:

- Cycle 1 (1986-1993): D&O coverage came to fill the gap in community bank coverage
- Cycle 2 (1994-2007): Monetary System internet services were brought on line.
- Cycle 3 (2001-2008): A new PMI program and state market were opened up.
- Cycle 4 (2009-2014): Management systems built around E-Board.com rolled out.

Cycle 5 commences now, with the ushering in of First Monetary's Institution Affiliated Party Program, the creation of new class of membership and new risk management protections for the Directors, Officers and Staff of Community banks.

From our sheltered Bermuda cove, we will now recap our 2013 performance, survey the seas and lay out our chosen path for moving out ahead of the chop. Greetings and welcome home once again!



2013 Operational Highlights

- FM will pay its seventh consecutive dividend and post its ninth consecutive profitable year;
- A premium stabilization fund remains in place. The current balance of stands at almost \$700,000 and is available for use to offset higher than expected losses or fund windup expenses;
- Operating costs have been effectively capped by PROPHET plan actions first introduced in 2004. While there has been some annual variability, overall expense figures have been reduced approximately \$120,000 since plan introduction;
- Conservative and selective underwriting continues the norm as membership is presently extended to only "C" or better rated institutions;
- D&O Income: Aggregate D&O Income decreased \$15,000 to \$134,417 during the reporting period, largely attributable to Member mergers. Most shareholders continue to maintain high primary commercial D&O limits, a natural outcome of continued softness in the D&O insurance rates charged to well-rated institutions. While these high primary limits reduce the cost of FM's secondary contracts, company exposure to loss is diminished, offsetting and partially diminishing the income reduction;
- PMI Income: PMI income tallied \$150,167 in 2013, down from \$192,430 in the prior year. The
 termination of FM's MGIC & Radian PMI reinsurance treaties will mean that earnings from this
 line will decrease and end over the span of approximately ten years;
- Investment Income: Low investment yields continue to hamper earnings. Viewed as a standalone component of revenue over the past 20 quarters, it is apparent that the decline in investment income has been a principle contributor to reduced profitability. Were 2013 interest rates on par with those of 2007, current company profit would exceed \$65,000;



2013 Operational Highlights

- D&O Claim Frequency / Severity: There were NO new claims reported during the period.
 After allocating all loss reserve activity, financial movement in the loss and loss expense reserve account amount to -\$35,852 for the review period. This development once again vindicates conservative reserving practices of the past and current underwriting/pricing models;
- Underwriting/Service Fees: Rex Wyon Services maintained its voluntary fee reduction during 2013 by reducing fees from \$120,000 to \$28,000 over a contracted period of agreement. Thirdparty audit, actuarial and legal costs remained flat, with no change anticipated through 2014;
- Director's Reimbursement Expenses: Expense reimbursements have been restricted in accordance with approved business plans. They are presently set at 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 present, 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 \$79,817 was expensed for meetings in 2013, a \$35,000 reduction from the previous period.

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 its ongoing commitment to assuring that resources remain in place to implement agreed upon strategy are key elements factoring into our management discussions and Board decisions. In riding out the changing tides of the past, our strategies have continuously evolved.

FM 1.0: The "Wraparound" Product Strategy

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

FM 2.0: The "Product Halo" Strategy

1995 saw a major market cycle adjustment and the 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, maintained broad limits and expanded coverage, you most certainly would not be reading this report. Recognizing that our small company could not 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 provided IT education, web hosting support and implementation services that obviated the need for high-priced consultants.

FM 3.0: 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 geared up a new 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 the state of Pennsylvania.

FM 4.0: The "Dynamic Stasis" Strategy

By 2004, the internet had become an interconnected world commodity and electronic payment providers moved into banking services. The banking industry was extremely profitable, and D&O insurers were tripping over themselves to insure financial institutions on terms our conservative company would not touch. A new dynamic stasis strategy was developed and implemented and guided all PROPHET to date. 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 restored FM to profitability and dividend paying status while preserving the ability to react to potential reversals in competitive markets.

FM 5.0 The "MEMBERSHIPhT" Strategy

At our last gathering, we spoke extensively to the new direction FM would be pursuing and implementing, framed within a "Blue Ocean Strategy". The "Member-SHIFT" tactic we are now taking fully embraces value innovation and differentiation in the effort to "shift the tide" in our favor and in the process create what would presently be an uncontested market space. The dimensional elements of the 5.0 plan address:

- 1. **Market Shift:** This product will create direct relationships with individual bank "Leadership" representatives.
- 2. **Product Shift:** The Institution Affiliated Party Program (IAP) will be added to the company's portfolio, putting in place and establishing a product that addresses exposures in the Civil Money Penalties.
- 3. **Service Shift:** Further enhancements and improvements to online services in support of both direct purchase and bank-owned policies will be put in place attendant to incorporation of a new web site (http://firstmonetary.co.uk) and introduction of an upgraded E-Board 4.0 Service.

Risk Management Summation

Under all past strategies and the new one we are charting, FM has perpetuated its conservative risk profile: First Monetary ("FM") is a non-assessable mutual insurance company chartered in Bermuda. All strategic plans are executed in accordance with Board approved policies, practices and procedures anchored by solid balance sheet analyses. Accordingly, FM places significant emphasis on management of the following risks:

Asset Quality & Liquidity

One source of FM income is investment earnings on available funds. These amounts are directly determined by capital 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. It has relied exclusively upon returns from certificates of deposits deposited with FM members or US Government backed securities for source funds. All individual certificate values carry limits less than FDIC guarantees. We again note that the level of investment returns remains depressed given a perpetuation of the low interest environment.

Quality & Appropriateness of the Reinsurance Program

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

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

Liquidity

During the year ended December 31, 2013, Company cash flows from maturity of certificates of deposit, Directors' and Officers' Liability insurance premiums and interest earned were sufficient to discharge obligations and meet statutory liquidity requirements. That result was achieved with the full support of Rex Wyon Services, who under agreement voluntarily reduced its management fees during 2012 and 2013 by a total of approximately \$100,000.

Previously announced CFPB actions that placed First Monetary's MGIC PMI treaty into run-off during 2013 will continue to negatively affect the Company's operating cash flows for the near future. PMI premium receipts continue to be placed into the corresponding Trust account, but the Company is precluded from receiving any near-term distributions.

This impact on cash flows is not reflected in the Company's Statutory Return or Declaration of Statutory Ratios. For reporting 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 difficult and imprecise. FM has felt it wise to build in a small margin of safety should claim reserves prove less than adequate to respond in specific circumstances.

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%. In such a 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. Our approach to management and our current position can be summarized as follows:

- FM's standing policy is to maintain a loss reserve ratio that does not exceed 2:1
- FM's 2013 loss reserve ratio was less than 1:1

Capital @Risk (CAR) - Capital Formation and Adequacy

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

Solvency ratio: This ratio represents the maximum amount of premium that FM is permitted to write on a net basis compared to its capital and surplus position. In Bermuda, a 5:1 ratio is permitted. This ratio permits FM to write up to \$6MM based on currently held assets.

While regulation permits a 5:1 ratio, FM routinely adheres to a far more conservative 2:1 maximum limit. FM's capital and surplus are derived from members who make single reserve premium contributions equal to 50% of their first year annual premium a calculated under maintenance of a \$500,000 policy. The sum generally ranges between \$2,500 and \$6,000. Using this set figure, FM can maintain a minimum 2:1 solvency ratio as members join the company.

• With respect to 2013, FM's 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 "wraparound" contracts.
 - Both ratios were maintained in 2013

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. Problems evidence themselves in downturns, where institutions confront a painful "double whammy." At the very time they are confronted with the need to build reserves, they face situations where:

- Insurance markets close when MOST needed
- Insurance costs rise when affordability is a primary concern

• First Monetary: Counter-Cyclical Management Strategy

In stark contrast to commercial insurance, FM has taken a contrarian approach to management of underwriting cycles. Our method is better suited to periods of economic stress, when the actual risk of loss is most tangible. It offers peace-of-mind that comes with the certainly of knowing that insurance will continue to be available, and at affordable rates.

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

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

FM's existing D&O Program has carried us through many tide changes is more than capable of riding out this one. At its present premium volume, however, it is insufficient to carry us alone. That is where the new program we are introducing at this conference comes into play.

Enter the IAP Program...

In a Financial Institution Letter issued 10 October 2013, the Federal Deposit Insurance Corporation (**FDIC**) formally laid out and restated its previously announced position that no insurance coverage (or indemnification) that paid for fines and penalties should be attached to any bank insurance policy or indemnity agreement.

The resulting fallout prohibits Member Banks from purchasing D&O policies that can be used to pay or reimburse directors, officers or employees -- each defined as an institution affiliated party (IAP) -- for the cost of any civil money penalty (CMP) assessed against them in administrative proceedings or civil actions commenced by federal banking agencies. There is no exception that would permit the IAP to reimburse an employer for the cost of liability coverage even if it was available under the provisions of a policy they owned. Many commercial carriers have responded by simply excluding CMP coverage from bank issued D&O policies, leaving the problem entirely unresolved.

Rather than walk away from the issue, First Monetary has developed a program that can effectively close this gap in protection, a program very much in keeping with our mission to protect decision-makers at community banks.

Our detailed analysis of the problem has revealed an approach that permits First Monetary to leverage its existing D&O treaty in such a manner the CMP protection can be extended in a manner that complies with FDIC stipulations. We have determined that the Company can meet regulatory requirements by issuing IAP policies directly to bank directors, officers and managerial staff rather than the bank to which they are affiliated.

A cursory outline of the proposed IAP program lays out along these lines:

- 1. Part One of the new program coverage will offer D&O protection against conventional risks the bank and its IAPs confront in excess of the Member Bank's primary program.
- 2. Part Two of the new program will offer primary protection against CMP exposures, but will be issued directly to the IAP.

We have pre-determined that extension of this new IAP protection policy will not present First Monetary with any issues pertinent to an increase in the volume of unrelated business. Recipients who are issued IAP policies will become members of First Monetary, but will not be required to make capital contributions to the Company, as is the case for Member Banks. Voting rights will be curtailed as a direct reflection of the fact that these policyholders will have no capital interest in the company.

Initial availability of the new IAP policy will be restricted to the qualified insureds of First Monetary Member Banks, permitting premium volume to accumulate and simultaneously addressing the immediate exposures of shareholder organizations. Once a sustaining base has been reached, the Company will further extend the availability of IAP coverage to non-Member institutions. With groupwide buy-in, it is projected that this objective could be achieved by 2015. A successful launch would be defined as the achievement of a \$50,000 premium volume prior to the open market introduction date.

All major impediments to rollout of the program have been successfully overcome. A mechanism for direct payment of premium has been negotiated with the Bank of Butterfield, corresponding IAP policy language has been formulated and the working facets for program administration have been put in place.

The new IAP has also received a practical endorsement by Lloyd's of London in the form of reinsurance support. In the lead-up to this meeting, they signed on to a compact that allocates and additional \$250K in reinsurance for extending the new cover. As an indication of their comfort with the program and the solid, long-term relationship they have enjoyed with First Monetary, the extension carries NO ADDED REINSUANCE COST! The new reinsurance package that became effective 1 May was renewed under the same broad terms and conditions as the expiring contract, another positive result that will hold premium costs flat from year-to-year.



Shifting with the Tide

The successful development and Integration of IAP policy coverage into First Monetary's product portfolio proves that our company retains a solid capacity to fill critical niches in the community bank insurance market and that it can respond to emerging risks we confront far more rapidly than slow moving behemoths of the insurance industry.

First Monetary's IAP program provides an important risk management solution to the decision makers at community banks that may also stimulate conversations with institutions beyond our traditional base.

By virtue of the unique ability of our product to close a tangible coverage gap executives from all financial institutions know to be real, First Monetary is shifting with the changing tide, and positioning itself on a crest that we can successfully ride to the other side.

On a personal note, I'd like to thank you all for keeping faith through trying times. It was a pleasure to work with Tom Piche' as Chairman, and welcome Richard Meares to the Chair this year.

In behalf of the team, I trust you're all looking forward to our 30th anniversary celebration as much as we are.

Warmest Bermudaful Regards,

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Frank J. Shashaty, CPCU

President & CEO

First Monetary Mutual Limited