

Agenda Item Five

President's Report

Another milestone.... This year, FM marks its 20th anniversary as a member-owned insurance company. While we've experienced growing pains along the road to maturity, our member's unwavering appreciation of the company's inherent value, and their unflagging support of the risk management decisions made to maintain it, has carried us through adolescence. Now twenty years "young", First Monetary remains fully dedicated to protecting the decision makers at community financial institutions and solidly capable of doing so.



Francis J Shashaty, CPCU
President & CEO

It can now be said the company has successfully navigated and transitioned through each stage of the traditional insurance cycle. By adjusting and realigning our products, services and underwriting policies in response to developments, we've survived the unique challenges each step of the way. A quick examination of history reveals the changes and adjustments we've made during the transition from a high-cost, low availability insurance environment to the polar opposite in four year increments.

[The First 4 Years - The Crunch begins](#)

The mid-80's saw the commercial market withdraw from the community bank insurance market almost entirely. First Monetary was organized with 31 founding members to fill a critically important vacuum, providing just one line of coverage, Directors and Officers Liability insurance.

[The 5th to 8th Year - FIRREA's Impact](#)

Sweeping legislative and regulatory changes brought significant new regulatory and oversight requirements to community banks. These changes had direct effects on the size and composition of our company and the way it was run. While FM's membership declined as the result of enforced bank closures, coverage was consistently maintained through strategic underwriting adjustments that kept us ahead of the changes, addressed the key risk control issues of our reinsurers, and provided the support services members required.

[The 9th - 12th Years - ReUnderwriting & Recovery](#)

The community bank d&o market returned to profitability during this period as commercial insurers expanded their portfolios. As new entrants began to enter the market and provide protection, premium costs stabilized, then began a slow decline. Coverage limits and provisions expanded, sometimes in response to our own initiatives.

This change in the market represented FM's first treat from external sources. FM determined that it could not ignore nor win a protracted competitive competition with the larger commercial insurers. In response, FM implemented a Membership services strategy that would keep and attract Members based on innovative value added services. The first innovative service, the INTERmoNETary System, provided all FM Members with internet web sites in early 1995. This innovative idea had profound effects that continue to this very day. FM Members represented 40 of the first 200 banks with an internet presence during the internet infancy period. Perhaps more lasting, FM Members gained valuable educational insight into this emerging technology and many 1995 Members have desirable dot-com domain names today as a result of those efforts.

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The result - FM's membership solidified into a core membership that carried us until our recent expansion into Pennsylvania.

[The 12th - 20th Years - Competition Returns](#)

A rapidly escalating drive by commercial insurers to build market share during this period led to significant declines in premium, paired with dramatic increases in coverage limits and policy terms. That same drive has been paralleled by significant declines in profitability that will ultimately set the stage for a new round of market corrections.

First Monetary rode this wave of bargain-basement coverage availability as far as it could possibly carry us. We shed risk, moving from primary to excess positions on many policies. The resultant combination coverages led to lower costs and improved protection for members, without undercutting FM's risk exposures or attractiveness to reinsurers. New services, market expansions in New York and Pennsylvania and the first

PMI program for community banks helped maintain membership and avoid detrimental reductions in revenues. Coupled with cost-cutting initiatives, FM maintained itself as a viable organization and kept its balance sheet rock solid.

Where We Are Today

That brings us to today. Over the past year, First Monetary's operational results improved dramatically. Total income increased 10%, largely on the strength of continued growth in the PMI line, while expenses were simultaneously reduced 12%. As a result, losses from operations were reduced by \$130,000; at this rate we're on track to achieving a balanced budget by 2006. Two new services, E-board and E-forms, are promising additions to the services currently provided to Members.

For 20 years, FM has managed its affairs based on a market-cycle methodology. By avoiding the temptation to react to every dip and spike in prices, FM has ensured that solid D&O coverage and protection was ALWAYS available to members. While some may question the correctness of this strategy -- because it cannot always deliver profits and dividends -- we cling to the belief that it's the correct one. Many of these same people hold that insurance and banking organizations are also 21st century anachronisms, an assessment we disagree with no less strongly.

The management decisions we've made in the recent past respecting prices and policy coverage have been based on our desire to avoid the exact kind of problems now plaguing the overall insurance industry and D&O market in particular. While admittedly placing us at a competitive disadvantage, they ensure that we remain in firm control of our own destiny.

Problems in the Insurance Industry

In past years, we've used the shareholder's meeting to discuss issues facing the industry in general. Some years the issue has been asset quality. In others, the topic of discussion was the adequacy of claim reserves. This year, it's pricing and profitability concerns.

The news is full of reports about an industry embroiled in the finite reinsurance investigations -- the outcome of which will almost surely impact the business operations of many insurers -- and quite possibly influence the market cycle. Finite reinsurance serves a legitimate purpose in managing risk, but regulators are now unearthing a disturbing pattern of incidences where it's been improperly used to produce "magic" results on an entity's balance sheet and P&L statements.

FM's reinsurance programs do not now and never have relied on finite reinsurance transactions. Neither does FM provide

finite reinsurance to any member or entity.

Throughout our 20-year history, FM has avoided the kind of problem confronting the industry at large by applying disciplined strategies to the management of our balance sheet in three key areas:

- 1) Asset quality
- 2) Claim reserve adequacy
- 3) Reinsurance Quality and appropriateness

FM has taken appropriate measures to assure the integrity in each area. Assets are placed exclusively with member institutions in FDIC insured instruments; claims are conservatively reserved and traditional excess of loss and quota share reinsurance treaties are transacted solely with A-rated carriers

Problems in the D&O Market

There is an old saying that says, "A foolish act done over again will not improve things". As a thirty year participant in the D&O insurance market, I can readily apply this statement to developments in the 2004 D&O insurance market.

Reports confirm that carriers collected \$12 billion in premiums from 1996 through 2002, but paid out approximately \$32 billion in claims over the same period. Despite this painful reality, Market participants continue the completely irrational practice of reducing premiums and increasing coverage, all in the face of growing legislation, regulatory activity, litigation and corporate governance requirements. Something has to give. The only question is when.

Underwriting the |P|P| (Policy|Price) Relationship

The major marketing and operational difference between the commercial market and First Monetary is the approach each takes to managing the |P|P| relationship.

Since 1996, it's been standard practice for the commercial companies to compete through modifications of the |P|P| equation. This approach has spawned a whole slew of policy extensions, including entity, bankers professional and lenders liability coverage. While FM is not averse to taking on additional risk exposures, we take exception to the prices being charged in relation to the liabilities assumed. Typically, these coverages generate less than 15% additional income, a figure that on its face appears far too small to offset the exposures the new risks being taken on. FM's internal claims studies show that FM's loss development would have increased more than 100% had coverage extensions been included in current D&O contracts. Given these realities, FM has not and does not plan to broaden policy terms and reduce premiums just to compete with the commercial markets.

In lieu of increasing its risk exposure, most FM policies have been renewed as second position contracts. By allowing Members to attach their D&O policy as wrap around coverage, Members can adjust to the changing conditions in the commercial market. This maintains FM's objective to support and complement the commercial market products rather than to compete with it.

Underwriting – Securities Litigation

Litigation, with specific reference to the number and type of claims being filed, has been and continues to be the primary predictor of directors and officers liability. The increased frequency and severity of securities class and derivative actions is now well documented. Average securities settlements costs as reported by Price Waterhouse Coopers Securities Litigation Surveys were \$23.2 million in 2003. A separate annual claim report from Tillinghast confirms dramatic increases in this area. Greater participation by institutional investors as lead plaintiffs will make litigation even more costly to defend and resolve going forward. While the average small to mid-market cap entity claim is reported at less than \$5 million, mega-cases from large-cap market entities have dramatically increased.

FM's Underwriting Approach

The willingness of commercial companies to provide broad policies with high limits at very low premiums has been turned, in some respects, to our advantage since 1996. For the past 6 years, stockholder litigation has been the largest and most costly area of D&O litigation. The inclusion of IPO conversion coverage in many commercial policies has presented FM with a new way to shed risk. FM has implemented an underwriting strategy that reduces loss exposures by exiting the primary D&O market entirely for publicly traded banks. To reduce them still further, FM has also discontinued providing primary coverage for mutual to stock IPO conversions.

FM required a \$2 million minimum primary policy beginning in 1997, and has been actively working with members to increase aggregate limits during the past several years. Most FM D&O publicly traded entities now carry primary limits of \$4 million or more.

Market Direction

In every trade publication, the same story is being echoed. The frequency and severity of losses shows no sign of abating, the backlog of unsettled securities claims continues to increase, but premiums continue to decline. According to a study by New York-based consultant Advisen Ltd., the average cost of securities class action settlements rose from \$25

million in 2003 to \$33 million in 2004 while D&O rates fell 10%. Despite so-far hollow claims from many carriers that they will refuse to follow the market's downward pricing trends, even if it means giving up underwriting the risk, current reality shows all major D&O carriers fiercely committed to competing for bank customers on unchanging terms. Competition will remain intense for 2005.

FM's 2005 Strategy

FM has determined that it will not compete with the commercial markets on the basis of the P/P equation, irrespective of how long this competitive cycle lasts.

For small companies like ours, this approach is problematic. While the easy decision would be to try to compete on P/P terms - lower premiums (reduce income) and expand policy coverage (increase exposure to loss), the end result is almost 100% predictable. It's our firm belief that FM would suffer long-term. The issue for 2005 and beyond is the strength of our commitment to stay the course through the remainder of this competitive cycle. Dramatic market adjustments are inevitable at some point in the not-too-distant future.

Faced with continuing challenges from large commercial insurers with overwhelming resources, FM will have to rely on innovation to hold on to current and attract new members. FM



believes its newest service, EBOARD, is up to that challenge.

The success FM enjoyed this past year was once again made possible by New York and Pennsylvania members who have been contributing to its progress every year for two decades. What ever the future brings, we can all be proud knowing that FM does not face issues in the key operational areas because of the attention we've paid to the fundamentals during our twenty years together.

Frank Shalaby