

## Agenda Item Five [A] President Report

I think it very appropriate to start out by saying that it's a great time to be in the D&O Insurance business... ***if you're a buyer of the product we sell.***

At its core, the insurance transaction is fairly simple and straightforward: you put your capital at risk for a fee. The challenge therefore is to assess the risk and set an appropriate rate corresponding to the level of assumed risk.

The maximum loss exposure to gross written premium ratio is a key way to assess risks assumed by insurers. Lower ratios mean insurers are assuming less risk because the premium component is higher.

In 1986, prevailing commercial market rates for D&O coverage, if obtainable, were approximately \$25,000 per million of coverage. This pricing model reflected a 1 in 40 ratio, or an estimated \$1,000,000 total loss for every forty banks insured. At that time, FM's pricing model was set using what we estimated to be a more realistic 1-100 ratio, or \$10,000 per million of coverage.

Today, however, commercial carriers are quoting rates as low as \$2,000 per million of coverage, a 1-500 ratio! That prompts two questions. Why have rates fallen so dramatically, and can they be sustained at such low levels?

Here is what NERA, an international economic consultancy expert, has to say about it. NERA recently released a report titled "Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar."

The report indicated a marked downward trend in the number of securities class action claim filings: 246 in 2004, 211 in 2005, and a projected figure of only 135 for 2006 (based on the 129 claims made as of December 15, 2006). In fact, 2006 filings were the lowest annual level since 1996, a year that was already unusually low because many cases were moved to state courts in an effort to bypass the restrictions imposed by passage of the Private Securities Litigation Reform Act (PSLRA) during that year. The drop in 2006 is perhaps even more significant because 22 of the 129 filings involved options backdating claims, a probable one-time event.

Another key finding of the NERA study was that the dismissal rate (i.e., the probability that a court will dismiss a claim on a summary judgment basis) rose to 38.2 percent during the 2004 to 2006 period, compared to just 19.4 percent in the years from 1993 to 1995.

In contrast to the decrease in claim frequency, average settlements in 2006 increased 37 percent relative to 2005, even excluding the partial Enron settlement and three other settlements exceeding \$1 billion. Nevertheless, it should be recognized that a number of these claims had been in the pipeline for more than 5 years. Moreover, median settlements, a better indication of actual severity trends, rose about 4 percent in 2006, to \$7.3 million, from \$7.0 million in 2005.

Despite a slight rise in claim severity, the commercial insurance market believes the precipitous drop in claim frequency indicates that underlying conditions have changed for the better. They seem to have concluded that absent a dramatic stock market correction or a return to the frenzied class action claim activity experienced in the early part of this decade the case for D&O premium rate reductions is convincing.



Francis J. Shashaty  
President & CEO

Time will tell whether insurance companies are placing their bets correctly. At current pricing levels, it would take 500 years for them to recover a modest \$1,000,000 claim, and it hardly appears that the carriers are covering their basic policy costs now. First Monetary certainly couldn't. If D&O was this company's sole source of revenue, we'd be an interesting footnote in annals of captive history now.

Fortunately, that's not the case. First Monetary long ago took it upon itself to cede primary responsibility for D&O risk to those eager and willing to put themselves on the hook for it, diversify to create revenue streams from other sources, and whittle down company expenses to levels commensurate with our altered profile. In terms of composition, character and capabilities, FM is very much the same company it always was, and just as financially sound. Our decision NOT to compete on a losing battlefield would have made Sun Su proud.

The "dynamic stasis" strategy put in place and adopted as part of the 2004 PROPHET plan left First Monetary in a position where it can survive and prosper in the near-term by effectively standing in place, but flexible enough to adjust to almost any foreseeable change in the core business or business environment reasonably quickly. That flexibility will increase in July. With the maturation of the PMI insurance trust that month, FM will fully command its destiny.

Whether you attribute our good fortune to luck or skillful management, the stars are currently lining up for a steady pattern of revenue growth. PMI income will maintain its positive slant, and should exceed \$250K in 2007. The positive impact of rising interest rates was only partially realized in last year's financial results. Interest income is expected to contribute an incremental \$30K to the bottom line this time around. Expense reductions on the legal, accounting, marketing and reinsurance lines of the income statement will pad the margin and provide a cushion to maintain it. You could, very soon, be in a position to decide how much of the company's profits you want back, how fast you want them, and whether you'd prefer to take them in the form of dividends or meeting reimbursements.

With profits steady and growing, it's reasonable to expect that the prospects for new memberships would be enhanced. Almost paradoxically, there's no need for the company to aggressively pursue them, and wisdom in not doing so. Recent US tax law changes permit FM to tally up to \$600K in underwriting and investment receipts without tax consequence. This change, together with the expense reductions already in place mean FM Members should realize positive financial results for several years to come. It also means that deferring the date we exceed \$600,000 in gross revenue is very much in our interests.

One side benefit of this fortunate quandary is the added attention we've been able to devote to the new Member Services. As of this writing, every member bank has been provided an E-Board account. This secure online data transfer, forms management and communications system rated its own feature in ACB's publications, and is coming into its own as a tool institutions can leverage for promotion, savings and efficiency.

I'd like to thank you all once again for the faith you placed in FM through the trying times. I'm sorry that I can't express that sentiment with our dear friends Anthony Monteverdi and Eric Arcay in attendance. They will both be sincerely missed.

Frank J. Shashaty



President & CEO  
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