

Agenda Item Five [A]

President's Report: Risk Management
Perspective Matters

Welcome Home!! The dictionary cites one definition of the word "Perspective" as "The faculty of seeing all the relevant data in a meaningful relationship". Just as we have for the past twenty-plus years, FM is going to be talking lots about "Risk Perspective" in the two-day course of our current AGM session and how it impacts our mission to "Protect the Decision Makers at New York and Pennsylvania Community Banks".

Let me start with the premise that company size matters. A small company's view of the world in which it operates differs substantially from that of a powerhouse business, much the same as a child's view of the world differs from an adult's. I have a personal story to complete the analogy.



Francis J. Shashaty
President & CEO

When our son Joseph was five years old, his school held an outdoor field class entitled, "A child's perspective of NYC". Each child was provided with an instant camera, and told to take 36 pictures of anything they thought interesting for their "class assignment".

The resulting pictures provide fodder for a classic study in perspective. You no doubt have seen pictures taken by tourists and NYC travel postcards showing the UN, Empire State and Chrysler Building. Joseph's pictures, by contrast, focused on things much different from landmarks. They included a "Johnny pump" (NYC fire station), open metal doors, basements below street level, a picture of a sewer, an overfilled garbage pail and a sidewalk with some "foreign matter" on it.

Using this story to set the stage and frame discussions, we consider the following important questions:

- "What was the financial industry's risk perspective just one year ago?"
- How has the commercial market managed the sub-prime mortgage and broader credit meltdown?
- What impact will the subprime issue ultimately create for D&O Insurers?"
- What did FM do and how did it fare by comparison with major insurers?

You'll recall the fierce competition that we reported amongst commercial companies for D&O insurance business in 2007. Apparently focused exclusively on their fight for market share, and in full faith that the comparatively low-level claims volumes of 2006 would continue, the commercial market operated from the perspective that a continuance of very low D&O premium rates was justified.

You no doubt are aware of my reactions to ongoing rate cuts and my personal observations on their recent levels. In my words, "Time will tell whether the insurance companies are placing their bets correctly. At 2007 pricing levels -- it will take an insurance company 500 years to recover a modest \$1,000,000 claim, and it hardly appears carriers are even covering their basic policy costs now."



To say the major carrier's perspective of the same market we service differed dramatically from FM's is an understatement. Looking back, we can certainly take satisfaction in the knowledge that ours has proven to be a far more realistic one than theirs. This merits talk on what frames our perspective of risk -- how we've managed it and where we should be taking FM in the coming year and years.

I've been personally moved, touched and influenced by the simple risk management principals of investment adviser and Professor Peter Bernstein and that "Sage of Ohama", Warren Buffett. These two invisibly guide my decisions.

At age 89, Peter Bernstein has witnessed just about every financial crisis of the past century. His 1996 book, "Against the Gods: The Remarkable Story of Risk", won many awards, and was well received in both the popular and academic press. In a recent interview with the Wall Street Journal, Mr. Bernstein shared his views on today's troubled financial markets.

Bernstein's take of the situation? "You don't get into a mess without too much borrowing. The current market problem was sparked primarily by hedge funds, unregulated by government and largely unregulated by the owners who gave managers their broad marching orders."

Bernstein's assessment of the future? "When you think about how all this will work out in the long run, we are going to have an extremely risk-averse economy for a long time. A lesson has been painfully learned. That's part of the problem going forward. You don't have a high-growth exit from this situation, as you've had from other kinds of crises. We won't have a powerful start, where the business cycle looks like a V. The shape of the current business cycle will resemble an L, where it goes down and doesn't turn up. Or like a U -- a very flat U. The reason I say this is that people aren't going to get caught in this bind again. They will tell themselves, "I'm too smart to do that again", and everyone else is going to be saying the same thing. The interesting thing is that this is going to be a WONDERFUL environment in which to take risk, because there aren't going to be any excesses."

A supporting philosophy is espoused by Warren Buffet: "I always say you should get greedy when others are fearful and fearful when others are greedy."

Back to the subject of FM. What do these expert perspectives on risk have in common with FM's risk strategy? In point of fact, they are reflected in the founding philosophy that has guided FM since 1986. That tenet of our existence states the following, "FM will complement, and not compete with the commercial market". In practice, it translates into actions where FM sheds risk when price/exposure ratios are favorable and increases risk only when appropriately profitable.

So how exactly does FM manage its underwriting, investment, and strategic risks? Read on for answers.



Underwriting Risk

D&O

Underwriting risk is the risk insurance prices won't cover the corresponding level of insurance claims.

When I get questions about FM's D&O risk perspective, I point to concrete examples. From the tsunami that washed away coverage for community financial institutions and led to the company's founding in 1986, to the more recent shedding of securities coverage and refusal to match insane premium policies, our Slavic devotion and philosophical approach to the minimizing underwriting risk has served us well.

As I've pointed out many times, the property/casualty (P/C) insurance industry is cyclical. There are periods of soft market conditions where premium rates are stable or falling and insurance is readily available. These are followed by hard market conditions, where rates rise, adequate coverage is more difficult to obtain and insurers' profits increase. FM has thrived and survived in both environments. What insurers attempt to avoid throughout the process is underwriting risk.

What influences the price, availability and security of insurance products? As you might expect, the answer is – "many things." Some factors are external, such as changes in interest rates and the stock market, regulatory activity, the number and severity of natural disasters, growth in litigation and rising medical costs. Others are internal and specific to an industry, such as competition. Of all the factors that drive the P/C insurance cycle, competition is dominant, and we've confronted it head-on since 1995.

A marked shift in the D&O occurred that year with the passing of Private Securities Litigation Reform Act ("PUSLRA"). The original intent of this act was to address the frequency and severity of securities class-action litigation that many companies (especially those in the technology sector) were being subjected to by professional plaintiff firms.

With the passage of PUSLRA, the commercial D&O market's risk perspective changed. Convinced that they would now be effectively insulated from lawsuits, competition for market share began in earnest, and has continued to date. With the passage of time, it has driven commercial D&O rates down to the functional equivalent of 1985 levels.

FM is not an organization that reacts speculatively to the passage of legislation. We manage by observing real world trends and statistics. While the commercials have been rushing to cut rates dramatically, we've trimmed ours while continuing to monitor developments closely.

While our choice of path has not yet been fully vindicated, our actions are proving prudent. While Congress "thought" PUSLRA would limit suits, all its passage actually did was alter the game and shift the playing field. According to the latest National Economic Research

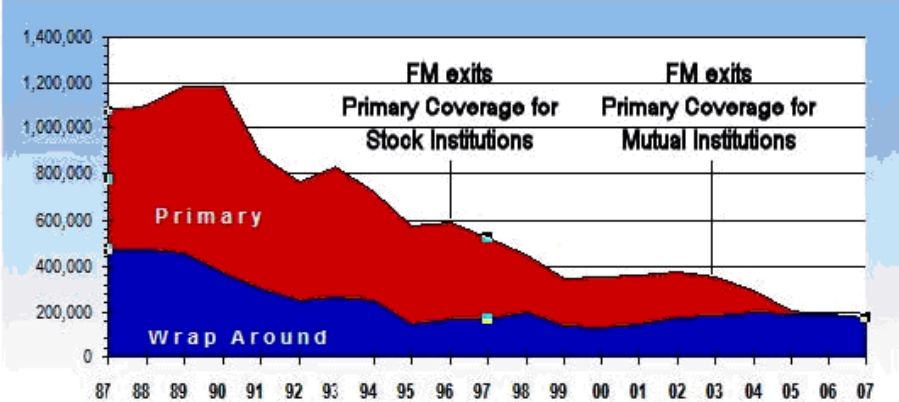
Agenda Item Five [A]

President's Report: Risk Management
Perspective Matters

Association research, the volume of securities class-action litigation filed since 1995 has steadily increased and awards have steadily risen. And the core element of claim expense is the cost of litigation. Since 1985, the hourly rate charged for a senior partner at a national firm has increased 100 to 300 percent. Fold in higher operating costs and diminished investment returns for the insurance companies themselves, and you have to ask yourself how long a 1985

cost structure be supported. The tide must turn eventually. The question becomes, "Why it is taking so long?"

That's not to say First Monetary hasn't taken full advantage of the delay. FM long ago ceded primary responsibility for D&O risk to companies eager and willing to put themselves on the hook for it. We exited the primary D&O market for stock institutions in 1996, and when the risk management matrix showed that the commercial market's appetite for business made it advantageous for FM to exit the primary market for mutual institutions in 2004, we left that as well. As of this writing, FM has no primary risk exposures at all. Here's the picture charted graphically ...



The same year FM shed its last primary mutual exposure, we also took the unprecedented step of reducing D&O exposures for the \$3,500 membership level, from \$500,000 per claim with a \$1,000,000 aggregate to \$300,000 per claim and a \$600,000 aggregate. Our rationale was simple. We had concerns about the overall risk profile of this grouping and the commercial market provided adequate coverage on very favorable terms. FM didn't need to.

Make no mistake, FM is delighted that the commercial market continues to provide broad-based coverage at low cost. It's better for Members and – from the underwriting perspective we've been discussing -- better for FM. While the need to maintain a company like our in this environment can be called into question, there is a benefit to doing so when viewed from the perspective of STRATEGIC risk. This will be covered in a follow-up section.



EPLI

Changes in risk perspective are by no means restricted to a single line of coverage. You'll note from the financial report that FM's Employment Practices Liability Insurance (EPLI) product is no longer a revenue producer. The reasons again involve risk verses return.

In response to a different kind of need by shareholders, FM implemented an EPLI program more than a decade ago. At the time of the program's launching, minimum premiums charged by the commercial market for comparable coverage were considered excessive by many community institutions. Complicating matters, policy issuance mandated adoption of formal employment manuals as a prerequisite for coverage – something many members lacked, and an item that would require a substantive investment of time and money to produce from scratch. In answer to both problems, FM pieced together a 100% reinsured program with Lloyds of London. Its unique structure permitted FM to earn a 15% ceding fee for the work product, but assume virtually no risk. To round things out, FM packaged the insurance product with a template employment manual readily adaptable for use by the membership, eliminating individual development costs and speeding rollouts.

The program was an instant hit, which made it a formula for imitation. Over time, comparable EPLI products were mirrored by the commercial market, which eventually matched, then beat, the FM program's delivery cost. When the only alternative to staying competitive involved a reduction of reinsurance expense and assumption of risk, we moved on. From our underwriting risk perspective, the \$10,000 income potential did not warrant the additional exposure. Maintenance of the model employment handbook remains a stock benefit of FM Membership.

PMI

At its core, the current subprime crisis resulted from incorrect assumptions that housing values would continuously increase and borrowers would always be able to manage their monthly payments. Since bankers are in the business of issuing mortgages, they're on the hook for credit risk and need ways to manage it, especially for borrowers of lesser means.

FM responded to the need for a credit risk management produce by creating the first PMI captive insurance program for community banks. This ten year old product permits Members to manage credit risk exposure while earning underwriting profits on their portfolio. Amid all the turbulence and tumult of the current mortgage market, it has remained a bastion of stability, and its attractiveness has increased. In fact, the program's fundamental growth, soundness and success made it possible for FM to increase its risk share from 18 to 25% of the cumulative MGIC portfolio this year.

Investment Risk

There are various kinds of risk directly or indirectly associated with investment management. They involve performance, returns, liquidity and portfolio structure. Investment risks



substantially impact the asset side of the FM's balance sheet and directly effect FM's overall liquidity. Improper management could potentially lead the company being over-indebted or even insolvent.

FM has consistently maintained the same conservative perspective with respect to investment risk as we have with underwriting. We want no deal with as little of it as possible. First Monetary

assigns high importance to liquidity, security and marketability of its assets. Management long ago implemented an investment policy that directs all available funds to CDs. These are parceled out to members exclusively in bundles not exceeding \$100,000. Funds available for investment are determined by FM's capital and surplus, adjusted for expectations on the timeframe for incurred losses to be paid.

Strategic Risk

The capstone to all of this is strategic risk. In the grand scheme of things, FM's risk management perspective with respect to both underwriting and investments feeds into the longstanding desire to ensure that First Monetary survives and is available to respond when markets ultimately turn, to plug deficiencies that crop up in commercial-based products, to ensure that desirable coverage remains available, to provide potential returns in the form of dividends, to leverage group purchasing and negotiating power and, finally, to provide support and counseling to members who need help with their own risk management practices and policies.

In the face of a market that remains stubbornly competitive, scaling back FM's risk exposures to their absolute minimums holding expenses down has made absolute sense, and ensured that that the company could go on meeting its strategic risk goal of "being here". FM will never be the biggest kid on the block, but with the application of sound principles and the help of supportive members, we haven't been driven out of the neighborhood.

Commercial insurance companies simply meet the risk financing needs of customers. FM, through its association with Rex Wyon * Monetary System, creates and provides a package of coverage and services that represents a risk management VALUE worth form one to five times paid-in premiums. Beyond insurance, this package delivers important benefits, useful management support tools and valuable subscription enhancements:

- E-Board Version 3 (<http://e-board.com>) Value ~ \$5,000 to \$15,000
- American Banker Online: Value ~ \$300 - \$1,800
- Online access to Mortgage Thrift News: Value ~ \$300 to \$1,800
- NEW!! Online access to Credit Union Journal: Value ~ \$300 - \$1,200
- Shareholders Meeting Expense Reimbursement: Value ~ \$400
- INTERmoNETary Web Services: Value ~ \$1,000 to \$5,000
- D&O CRA Liability Insurance: Value ~ \$2,500 to \$3,500
- Employment handbook/policy templates: Value ~ \$250 to \$3,500



Summation

FM turned in one of its best performances in the past ten years in 2007. Earnings increased and FM was profitable for the third consecutive year. Best of all, this culminated in payment of a \$50,000 dividend to the membership. Specifics are fully outlined in the financial and profitability ratio reports that accompany this presentation.

As far as our “perspective” goes with respect for 2008 returns, it’s one of cautious optimism. The outlook for D&O and PMI claims activity remains favorable, with member participation stable. We won’t escape the impact of lower investment brought on by historic Fed rate reductions of recent months, but with claims and expenses static, a new MGIC PMI agreement in place, and IRS tax-exempt status secured, the company is on track to turn in a good performance.

FM’s positive operational results and prognosis reflect an ongoing and continuing commitment to operational efficiency and transparency in governance. Our solid underwriting performance is directly tied to the efficient management of our shareholder institutions. Congratulations all, and thank you for keeping the faith through trying times. I regret that can’t express that sentiment with a dear friend in attendance. I’m sure I speak for all when I say that Charles Kleis will be sincerely missed.

A handwritten signature in blue ink that reads "Frank Shashaty". The signature is fluid and cursive.

Frank J. Shashaty
President & CEO
First Monetary Mutual Limited