

Article Title: ARCHIVE | Criteria | Insurance | Bond: Bond Insurance Industry Boards Of Directors' Standards And Practices Data: (EDITOR'S NOTE: —This criteria article is no longer current.) Weak corporate governance practices can, and have, negatively affected bond insurer ratings. Conversely, sound policies and capable, experienced board members can support and enhance financial strength ratings. Unfortunately, across Corporate America, there are a number of recent examples of corporate boards of directors failing in their fiduciary responsibilities, much to the detriment of shareholders and other constituents. In this current challenging credit environment, it is more important than ever for financial guarantee insurance company directors to have the appropriate expertise and independence and to actively and diligently execute their responsibilities. These responsibilities typically include: long-range strategic planning, setting financial goals, insuring accurate and transparent financial disclosure, evaluating and overseeing senior management, managing significant unanticipated events, and ultimately ensuring that the corporation acts in the best interest of stakeholders. This report focuses on the currently operating 'AAA' rated primary bond insurers. A subsequent report will review the reinsurers, niche bond insurers, and start-up 'AAA' primary company CDC IXIS. The governance and oversight history for the bond insurers is largely positive. In September 1998, our first report on corporate governance concluded that, for the then three principal public holding companies--Ambac Financial Group Inc., Financial Security Assurance Holdings Ltd., and MBIA Inc.--governance practices and board composition were sound and reasonable. Boards largely comprised outside directors with requisite skills and material financial stakes (common stock ownership) in the success of the company. The fourth 'AAA' primary company at the time, Financial Guaranty Insurance Co. (FGIC), was and remains a subsidiary of General Electric Co. Comfort was taken from the fact that many institutional investors and governance experts viewed General Electric's board positively. There are, however, some examples of bond insurer board missteps. For example, in 1999 the board of directors of reinsurance holding company Capital Re Corp. was less than successful in dealing with several high profile events, including a large claim in the asset-backed market and general market and rating agency concerns about the direction of the company. To make matters worse, the market was surprised by the board's announcement of the departure of the chief executive officer, and his subsequent replacement. In this case the board was not adequately attuned to the needs of key constituencies, and its action contributed to an overall negative reaction, especially in the stock market, with a corresponding diminishment in financial flexibility (the company's ability to raise new debt or equity capital). Perhaps not coincidentally, the Standard & Poor's September 1998 board of director report noted that a weakness of Capital Re's board was that none of its four outside investors had a material equity investment stake in the company. While material equity ownership in and of itself may not have guaranteed a different result, it is widely believed that board members are best aligned with shareholders when they themselves are substantial equity investors. The same year the Capital Re board mishandled the chief executive officer succession, by contrast, the MBIA board of directors managed a change in chief executive officer quite smoothly. Key constituencies had already been alerted and were given the opportunity to raise questions regarding the decision of David Elliott to step down as chief executive officer and the impending appointment of Jay Brown as the new chief executive officer. Marketplace reaction and acceptance were quite positive. Most recently, actions taken by the American Capital Access (ACA) board of directors contributed to that company's short stint on CreditWatch in December 2000. Information coming to Standard & Poor's from the board was often contradictory regarding the company's recapitalization, and related target dates would regularly come and go. Compounding the situation, ACA investors and the board representatives were pure financial investors, predominately motivated by a short-term return on their investments and associated exit strategies. As a result, the board took its eye off the ball in terms of expense controls, risk management, and other operational matters, and allowed capital to be rapidly depleted. Partly as a result of this experience, Standard & Poor's has modified its criteria for start-up bond insurers and now requires financial investors to be a minority in the overall investor mix. Table 1 Board of Director Structure, Composition, and Organization AMBAC FINANCIAL GROUP INC. FINANCIAL GUARANTY INSURANCE CO.* FINANCIAL SECURITY ASSURANCE HOLDINGS LTD. MBIA INC. XL CAPITAL ASSURANCE INC. Number of directors 8 13 12 9 12 Number of inside directors 2 Directors are either FGIC or GECC senior management Five directors are Dexia employees, three are current or former

FSA employees, and four are outside directors 2 10 directors are employees of the XL Group Directors attending less than 75% of meetings 0 0 Two (both subsequently resigned) 0 2 Are insiders excluded from any committees? Insiders may not serve on the Audit, Compensation, Nominating, and Corporate Governance committees N.A. No FSA current or former employees are permitted to serve on the Audit Committee; independent directors serve on every committee Insiders are excluded from the Audit, Compensation, Organization, and the Committee on Directors Both outside directors are assigned to the audit committee Is there a designated lead director who is not the CEO? No N.A. In the absence of the Chairman and CEO, the board can choose an outside director to lead a session In the absence of the Chairman and CEO, the board must chose an outside director to preside The vice chairman serves as lead director in absence of the CEO Are board meetings held with the CEO not in attendance? Yes, after each meeting There is no formal procedure to exclude the CEO There is no formal procedure to exclude the CEO from the full board meeting, but the Audit Committee meets once each quarter without the CEO or any current or former FSA employee present Yes, at least once annually There is no formal procedure to exclude the CEO Does the board have a CEO or senior management succession plan? Yes, a full procedure has been developed as part of the company's corporate governance practices Yes, the succession plan for CEO and senior management is coordinated by GECC Yes, there is annual review of succession plans by the Human Resources Committee of the board Yes, a procedure has been developed as part of the company's corporate governance practices Yes, at the holding company (XL Capital Ltd.) level *FGIC benefits from the oversight and management of the General Electric Co., and its board of directors. The General Electric Co. is FGIC's ultimate holding company. N.A.--Not applicable. With respect to the board of director structure, composition, and organization, board sizes range from a low of eight members for Ambac Financial Group Inc. to a high of 13 for Financial Guaranty Insurance Co. While there is no correct answer with respect to size, boards that are too large could run the risk of being unwieldy or unfocused. Conversely, boards that are too small run the risk of a lack of diversity in expertise or critical thinking. Corporate governance experts view board sizes ranging from between six to 12 as most appropriate. A second more critical board composition variable is independence. The more outside independent directors on a company's board the better. While some companies might portray a non-employee director as independent, if that individual is acting as a consultant or managing a firm that derives business from the company of which that individual is a board member, independence is questionable. Proposed New York Stock Exchange regulations define an independent director in that narrower context. The most conservative governance approach in this regard would be explicit prohibitions against a director's firm or company doing business with the bond insurer. Governance authorities believe that a maximum of two insiders is a prudent limitation. In terms of committees, excluding insiders from certain ultra-sensitive committees, such as audit and compensation, is most appropriate. It is also believed that having a non-chief executive officer lead director and having meetings with inside directors not in attendance allow outside directors to be more candid and proactive. Nonetheless, all the independence in the world does not matter if board members lack the expertise and industry knowledge to make crucial decisions. Ideal directors are successful chief executive officers or senior managers with comparable levels of responsibility, as well as relevant experience in areas such as capital markets, financial services, and insurance. Table 2 Governance Standards and Practices AMBAC FINANCIAL GROUP INC. FINANCIAL GUARANTY INSURANCE CO. FINANCIAL SECURITY ASSURANCE HOLDINGS LTD. MBIA INC. XL CAPITAL ASSURANCE INC. What policies, if any, govern interlocking directorates? Interlocking directorates are not permitted There are no situations of interlocking directorates for the FGIC board. FGIC employees are not permitted to serve on the boards of outside companies There are no policies prohibiting interlocking directorates, but no such relationships currently exist and in such an event disclosure is required There are no policies prohibiting interlocking directorates, but no such relationships currently exist There are no policies prohibiting interlocking directorates, but approval by the company's compliance director in context of company code of ethics is required Is there a limitation on the number of boards a director can serve on? No N.A. No No No Are directors provided with an explicit statement of duties? The various committees have a formal statement of duties Duties are described in the company's constitutive documents Duties are stated in the company's public corporate governance memo Duties are specified in the Corporate Governance Practices document, the various

committee charters, and company by-laws Only the audit committee Is the performance of the board evaluated? Yes, once a year Only in the context of their role as FGIC senior managers No formal evaluation procedure exists Yes, once every year Evaluations made in the context of the roles of certain directors as XLCA senior managers Are there prohibitions against the insurer's accounting firm doing consulting or other services? Current accounting firm provides no consulting services. Going forward, policy will explicitly comply with Sarbanes-Oxley Act of 2002 Company practice is that its accounting firm will not do consulting work There is no such policy, but such services and relationships are subject to board approval. In addition, the Audit Committee monitors the fees There is no such policy, but such services and relationships are subject to board approval External auditor may not perform consulting work Are directors subject to term limits? No, but age limitation is 70 No No No, but age limitation is 70 No Are there prohibitions against firms that employ outside directors doing business with the bond insurer? Firms currently employing outside directors are prohibited from doing business with the company N.A. No explicit prohibitions exist, but director business relationships must comply with company code of ethics The board believes that a business relationship is not sufficient reason to disqualify a director. Nevertheless, there are no directors with business relationships with MBIA No explicit prohibitions exist, but director business relationships must comply with company code of ethics N.A.--Not applicable. How a board operates and its standards and practices are as important as board structure and composition. In fact, one legislative outcome of recent corporate governance failures is the Sarbanes-Oxley Act of 2002. Among other things, this act will impose certain operational restrictions, such as generally prohibiting a corporation's auditing firm from providing consulting services. From a big picture perspective, providing the board with an explicit statement of duties can eliminate uncertainty about process and responsibility well before issues need to be addressed. Prohibition on interlocking directors, in which chief executive officers of two companies serve on each other's boards, is a conservative operating practice that is viewed as a positive way to further strengthen the independence of the board. In a worst-case situation, interlocking directors can create a quid pro quo type of relationship. At the far end of progressive governance theory are proposals for term limits for directors, to avoid the possibility of long-term relationships clouding judgment. No bond insurer has adopted this practice. Governance experts also believe that directors serving on too many boards may be inefficient, and some progressive governance standards limit the number of boards their directors can serve on. Finally, within the context of governance standards and practices, is the question of evaluating the work of the board members themselves. MBIA Inc. and more recently Ambac Financial Group Inc. have instituted formal review processes for board members. Table 3 Board of Director Compensation and Stock Ownership AMBAC FINANCIAL GROUP INC. FINANCIAL GUARANTY INSURANCE CO. FINANCIAL SECURITY ASSURANCE HOLDINGS LTD. MBIA INC. XL CAPITAL ASSURANCE INC. Compensation of outside directors? \$20,000 per year plus \$3,750 in stock options plus \$3,000 restricted stock units plus miscellaneous fees N.A. \$40,000 plus \$5,000 for subcommittee chairmen \$50,000 in restricted shares \$5,000 per meeting for outside directors Pension and medical or insurance benefits for outside directors? Directors are eligible for medical and dental plans and a \$50,000 life insurance policy N.A. No No No Outside director minimum stock ownership requirement? No N.A. Each current independent director owns more than \$2 million of stock, although there is no formal requirement to do so 5x their base fee No Number of directors owning less than \$150,000 in stock? None (excluding director appointed October 2002) N.A. None None N.A. Are there prohibitions on stock sales during board members' tenure? Black-out type prohibitions exist, but there are no long-term prohibitions N.A. Black-out type prohibitions exist, but there are no long-term prohibitions Black-out type prohibitions exist, but there are no long-term prohibitions Black-out type restrictions exist, but there are no long-term prohibitions N.A.--Not applicable. Perhaps there is no single more important issue that contributes to the positive motivation of a director than long equity ownership. While it is certainly possible that a director who owns no equity might be the most expert and most dedicated board member, there is an undeniable connection between substantial long-term stock ownership and acting in shareholders' best interests. Conversely, benefits that link the director more closely to the chief executive officer, such as pension or medical benefits, can be a negative. In our review we have chosen equity ownership of \$150,000 (excluding new directors) as defining what constitutes a minimum, material commitment on the part of owners. In the case of a bond insurer that is

a subsidiary of a larger group holding company, direct ownership is not always possible, but a review of the ultimate holding company's directors, their independence, and their financial stake in the group is undertaken. With respect to evaluating a director's economic interest in the company, stock options are as much of an issue for directors as they are for chief executive officers. Stock options in both instances are a risk-free way of accumulating wealth. It can be difficult to argue that an option holder is aligned with an equity investor when none of the director's own money is on the line or when no long-term holding requirement is in place once the option is converted. Ideally, the director-compensation plan should be structured to align directors with the long-term interests of stockholders. Paying directors in stock of the company is an ideal way to accomplish this goal. Ambac Financial Group Inc. Ambac's board is staffed and structured in a sound and positive manner. In October 2002, the size of the board was increased to eight directors. Two inside directors are in a clear minority relative to six outside directors. Several policies are in place aimed at preserving the independent characteristics of the outside directors. These include a prohibition on companies employing current outside directors from doing business with Ambac or its parent company. Also, certain key committees, including the Audit, Compensation and Organization, and the Nominating/Corporate Governance committees, are exclusively staffed with independent directors. The board met five times during 2001 and all directors attended at least 75% of related board and committee meetings. The board consists of well-qualified individuals, many current or former senior executives, with backgrounds in government/securities oversight, accounting, academia, banking, finance, consulting, and industrial management. While no outside director is designated as the lead director, separate and distinct from the chief executive officer and chairman of the board, the board meets informally after each meeting without the inside directors present. With respect to stock ownership, all of the directors (with the exception of the newest director named in October 2002) are substantial equity investors, with no director owning less than \$150,000 in common equity and the average market value for the outside directors of over \$800,000. On Oct. 15 2002, Standard & Poor's released a separate study on transparency and disclosure quality and practices for the companies within the S&P500; index, of which Ambac is included. Analysis undertaken included reviews of transparency and disclosure with respect to ownership structure and investor rights, information disclosure accounting policy details, board structure and compensation. Ambac received a very solid score of 8 out of a possible 10. Most recently, Ambac implemented an annual review and evaluation process for its directors. MBIA Inc. MBIA Inc.'s board and its governance procedures and standards are high quality. Board member backgrounds are impressive and diverse. Board expertise is apparent in investment banking, law, academia, insurance, banking, and legislative areas. MBIA has formalized many of its governance standards in its publicly available "Corporate Governance Practices" document. The document formally specifies the role and duties of the board and its committees. Among the requirements is a directive that chief executive officer performance should be reviewed annually, and the document defines a methodology for that performance. The board is also responsible for succession planning. With respect to meetings, the Corporate Governance Practices document provides that the board must, in the absence of the chairman, appoint a presiding director. Five to six meetings per year are called for unless circumstances dictate otherwise, and a minimum 75% attendance record is the expectation. The corporate practices document also provides, in an attempt to promote candor and unencumbered dialogue, that at least one meeting should be held excluding the inside directors. The document also specifies that the majority of directors must be outside directors. Currently, seven of nine total directors are outside directors. Family members, lawyers, or consultants to the corporation, or other persons with similar relationships, are excluded from board-member consideration. Insiders are excluded from the audit, compensation, and organization committees, and the committee on directors. Also excluded from board membership are employees or former employees of the independent auditor and employees of any company whose compensation committee includes an officer of MBIA. A very progressive requirement calls for director evaluation by the committee on directors. This committee is empowered to take appropriate action when warranted. MBIA is unique in the industry in instituting a minimum stock ownership policy for outside directors. As of the publication of the 2001 proxy statement, no outside director owned less than \$250,000 in stock or restricted stock. MBIA also received a score of 8 out of a possible 10 in Standard & Poor's transparency and disclosure

report. Areas where change would further strengthen the already strong governance structure could include revising the existing policy that allows interlocking directorates (although there are no current interlocking directorates). FGIC Corp. is the immediate holding company for FGIC. FGIC's ultimate parent (and ultimate board) is General Electric Co. (senior debt rating 'AAA'). Although there are no outside directors on the FGIC Corp. board, this circumstance is offset by the historical low-risk business strategy of FGIC as implemented by the General Electric board, combined with the financial strength of the parent company. Unlike direct public bond insurers, such as MBIA and Ambac, FGIC's governance review also necessitates examining the board and governance practice of General Electric, the ultimate board of directors. In addition to crafting the long-range strategy of the subsidiary, policies and procedures proscribed by the ultimate holding company are employed by subsidiary boards. With respect to the General Electric Co. board, A BusinessWeek special report, titled "Best and Worst Boards," characterized the General Electric Co. board as "a talent-backed board and a favorite with governance experts." General Electric Co. board member experience is extensive and quite diverse and includes a former senator, and numerous chief executive officers and senior executives with financial and industrial backgrounds. Observers also like the fact that directors are well-invested in General Electric Co. equity, and thus financially aligned with stockholders. On Nov. 7, 2002, General Electric Co. announced and published on its website the numerous steps it was taking to improve its overall corporate governance, including the independence of its board. Effective Jan. 1, 2003, the General Electric Co. board consists of 17 directors, including 11 independent directors, four insiders, and two outside directors who have continuing business relations with General Electric Co. General Electric Co.'s stated goal is to have at least two-thirds of the directors independent. The General Electric Co. received a score of 7 in Standard & Poor's transparency and disclosure study. The General Electric Co. board has also appointed a director who will chair meetings of outside directors or the board in the absence of the chairman and chief executive officer. These positive changes, along with continued improvement in the independent character of the board, have strengthened overall corporate governance for General Electric Co. Financial Security Assurance Holdings Ltd. In situations in which a lower rated ultimate parent company owns a higher rated subsidiary, as in the case of Financial Security Assurance Holdings Ltd. and its ultimate parent company, Dexia Credit Local (senior debt rating 'AA'), board of director structure and composition is especially important. The role of the board in FSA's situation is also important because of the desire of both companies to jointly provide new, synergistic products or services. Of potential concern is the possibility that less than arms-length transactions might occur, or that FSA could be disadvantaged in some way. When Dexia acquired FSA, Standard & Poor's received assurances from Dexia senior management that FSA would be allowed to operate in an independent manner. This independence has in fact been the case since the acquisition. The Financial Security Assurance Holdings Ltd. board totals 12 and includes four independent directors (one seat currently vacant), two present and one former FSA senior executives, and five senior Dexia executives. This results in the positive and unusual situation of the corporate parent controlling a minority of seats. These three independent directors are well known and highly regarded and, with the FSA members, committed to maintaining operating independence for FSA. The three independent directors each have more than \$2 million invested in FSA equity. Independent directors sit on every committee of FSA's board, and no FSA employees or former employees sit on the audit committee. Looking ahead, any change in mix or diminishment in the strong historical independent character of the outside directors would be undesirable. XL Capital Assurance is a wholly owned subsidiary of XL Capital Ltd. (senior debt rating 'A+'). In situations in which a lower rated ultimate parent company owns a higher rated subsidiary, as in the case of XL Capital Assurance, board of director structure and composition is especially important. XL Capital Assurance has two independent directors on its 12-member board. The ultimate board (XL Capital Ltd.) is composed of 14 directors. Much of the expertise of the board is insurance related. All board members with the exception of a relatively new board member are strongly linked financially with shareholders in terms of equity ownership. The board has recently instituted some changes that should strengthen the independent character of the board. Historically, several directors were previously executives of companies acquired by XL Capital Ltd. While this relationship raises questions of independence, XL Capital Ltd. management notes that a step such as this is sometimes necessary to maximize the value of the acquired company. At the start

of the year, two outside directors, likewise named to the board in connection with an acquisition, were also retained consultants. Because this practice likewise raises questions of independence, a new policy implemented this year states that consultants may no longer serve on the board. One director is also currently an officer of a company partially owned by XL Capital Ltd. In addition, at the start of the year, a number of directors were limited partners (with an XL Capital Ltd. subsidiary the general partner) of XL Capital Partners L.P., a broadly defined investment vehicle of the partners. However, to avoid the appearance of conflict, the partnership has recently been terminated. Looking ahead, continued movement toward truer independent, unaffiliated outside directors and more progressive governance standards would be viewed as a positive development for both XL Capital Ltd. and XL Capital Assurance. In conclusion, for corporations in general and the bond insurers in particular, trust and integrity has never been more critical. Boards are crucial in that regard. Standard & Poor's will periodically review and report on bond insurance governance matters and track developments in this increasingly important area. This report reflects solely the information received by Standard & Poor's Ratings Services in the course of its credit analysis of bond insurers. Standard & Poor's Corporate Governance Services, which offers corporate governance research and opinions, has not participated in this report.