

Global Credit Research - 25 Nov 2009

Oslo, Norway

## Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Aa1
Senior Unsecured	Aa1
Subordinate	Aa2
Preferred Stock	Aa3
Commercial Paper	P-1
Other Short Term	P-1

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## Key Indicators

### Eksportfinans ASA

	[1]2009	[2]2008	2007	2006	2005	[3]Avg.
Total assets (NOK billion)	234.33	296.90	218.72	172.36	135.93	[4]23.50
Total assets (EUR billion)	27.63	30.50	27.55	20.99	17.02	--
Total capital (NOK billion)	7.76	9.56	4.60	5.25	4.02	[4]18.61
Return on average assets	-0.53	1.35	-0.08	0.10	0.11	0.34
Recurring earnings power [5]	-0.97	1.87	-0.11	0.14	0.15	0.47
Net interest margin	0.66	0.47	0.31	0.31	0.30	0.36
Cost/income ratio (%)	-7.64	4.20	-806.10	44.92	50.84	-134.74
Problem loans % gross loans	0.86	0.05	0.02	0.02	0.04	0.06
Tier 1 ratio (%)	9.80	8.10	6.30	8.30	9.85	9.05

[1] As of September 30. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate. [5] Preprovision income % average assets.

## Opinion

### SUMMARY RATING RATIONALE

In accordance with Moody's rating methodology for government-related issuers (GRIs), the Aa1/Prime-1 ratings of Eksportfinans reflect the combination of the following inputs: (i) a Baseline Credit Assessment (BCA) of 4 (on a scale of 1 to 21, where 1 represents the lowest credit risk); (ii) the Aaa local currency deposit ceiling of the Norwegian government; (iii) high default dependence; and (iv) high probability of support.

Eksportfinans has a strong position in export lending - the institution has a legal monopoly over Norway's government-supported export schemes and is the only specialised export lender in the country. On 7 May 2009, Eksportfinans announced that it will sell its wholly owned subsidiary Kommunekreditt to Kommunal Landspensjonskasse (KLP), a Norwegian life insurance company, and going forward will focus on export finance. Kommunekreditt is a key lender to Norwegian local governments, with a market share of around 20%.

Eksportfinans's lending activities have a low risk profile due to the credit enhancement of its export loan portfolio via sovereign and bank guarantees. Interest and currency risks are contained, but we note concentration risks in the liquidity portfolio and liquidity risks related to structured funding.

In the prevailing turbulent market conditions, Eksportfinans has had access to market funding and also returned to the benchmark market in H2 2009 by issuing benchmark bonds in Swiss francs and US dollars. Eksportfinans's ability to attract funding on competitive terms is a key element of the institution's strategy given its wholesale-dependent funding profile and low-margin lending business. Access to government funding has been helpful, but we note the temporary nature of the facility that will be in place until the end of 2010.

We view the institution's default dependence as high due to its financial strength and business mix in relation to the credit strengths of the Kingdom of Norway, which directly owns 15% of the institution. In addition, the government has a further indirect holding via its 34% stake in DnB NOR, which owns 40% of Eksportfinans. The high probability of support in a distress scenario reflects Eksportfinans's importance to the government. The owners' support was demonstrated in the form of a capital injection in March 2008 and a portfolio hedge agreement to offset further losses in the liquidity portfolio. In addition, the government agreed in November 2008 to provide Eksportfinans with funding for qualifying export projects under the government-supported financing scheme. We note, however, that Eksportfinans does not benefit from a guarantee from the government.

### **Credit Strengths**

- Legal monopoly over Norway's government-supported export schemes
- Only specialised export finance provider in Norway
- Government's strong commitment and solid co-operation with other shareholders
- High loan quality, reflecting sovereign and bank guarantees
- Diversified funding base
- Large liquidity reserve

### **Credit Challenges**

- Continuing to offer efficient means of providing export finance
- Maintaining a low risk profile
- Low core profitability, although we note the recent improvement in the net interest margin
- Dependence on competitive international funding
- Ability to maintain a high-quality liquidity portfolio

### **Rating Outlook**

The outlook on Eksportfinans's long-term ratings is negative.

The negative outlook on Eksportfinans's long term-ratings reflects uncertainty related to its financial position given its focus on export lending going forward; the institution will be dependent on a single business line, which could make it more vulnerable to changes in market dynamics. Moody's acknowledges Eksportfinans's strong position as a provider of export loans and monopoly position in the government-supported schemes in Norway, but also considers export lending to be more cyclical than local government lending.

### **What Could Change the Rating - Up**

Upward pressure on the ratings is unlikely at this time given the recent downgrade and negative outlook.

### **What Could Change the Rating - Down**

As reflected by the negative outlook, Moody's will closely follow Eksportfinans's implementation of its strategy as a pure export lender and the impact on the entity's financials and overall franchise.

Downward pressure could be also exerted on the long-term ratings if Eksportfinans were to increase its risk appetite, particularly in relation to its financial investments.

Deterioration in core financial fundamentals (particularly profitability and capitalisation) and a weakening of the liquidity profile, or any sign of decreased commitment or support from the Norwegian government, would also exert downward pressure on the ratings.

### **Recent Results and Company Events**

#### **RECENT RESULTS**

Eksportfinans reported a good result from lending operations for January-September 2009, but net profit was adversely affected by the reversal of unrealised gains on financial instruments, which were mainly related to changes in the fair value of Eksportfinans's own debt, reflecting the tightening of credit spreads. In comparison, in January-September 2008, unrealised losses on the securities portfolio (now covered by the portfolio hedge agreement) had an adverse effect on the result. Regarding lending operations, net interest income improved significantly to NOK1.093 billion from NOK490 million in the same period in the previous year, reflecting higher volumes, margin increases and higher income from the securities portfolio.

The capital level is satisfactory - the Tier 1 ratio was 9.8% and the total capital ratio was 13.5% at end-September 2009. We note that changes in the fair value of Eksportfinans's own debt do not have a material effect on capital.

#### **COMPANY EVENTS**

On 7 May 2009, Eksportfinans announced that it had sold its fully owned subsidiary, Kommunekreditt, to KLP. Kommunekreditt was acquired by Eksportfinans in 1999 and is the second-largest provider of loans to the Norwegian local government sector, with around a 20% market share. The entity was sold at the book value and includes a loan portfolio totalling NOK42 billion, which accounted for almost 40% of Eksportfinans's loans to customers at 31 March 2009. Around NOK11 billion of loans to municipalities remained with Eksportfinans. Eksportfinans will provide funding for the acquired loan portfolio for a two-year period, during which time the loans will be gradually transferred to KLP in eight quarterly

instalments. The sale was finalised on 24 June 2009.

On 27 November 2008, Eksportfinans announced that it had entered into an agreement with the Norwegian government whereby the government would provide funding to Eksportfinans for the financing of new export lending that qualifies under the government-supported financing scheme. The funding will be provided for two years and with maturities of up to five years. The agreement was approved by parliament in December 2008 and by the general assembly of Eksportfinans and EFTA Surveillance Authority in January 2009. It reflects the weaker market conditions where the availability of market funding has not been sufficient to cover demand for export loans. In our view, the agreement also reflects Eksportfinans's function as an important tool for the government as a provider of funding to the Norwegian export sector.

In March 2008, Eksportfinans entered into a portfolio hedge agreement with the majority of its owner banks. The hedge agreement offsets losses of up to NOK5 billion in the liquidity portfolio, held as of 29 February 2008. The agreement also offsets any gains in the portfolio. Eksportfinans pays a monthly fee of NOK5 million to the banks participating in the portfolio hedge agreement. In June 2008, the Norwegian parliament approved the government's decision to participate in the portfolio hedge agreement (due to the government's 15% stake in Eksportfinans). As of end-September 2009, around 23% of the portfolio hedge agreement was used.

The owners injected NOK1.2 billion of new capital into Eksportfinans in March 2008. As a result, the Tier 1 ratio was 8.1% at end-March 2008, compared with 6.3% at year-end 2007.

## DETAILED RATING CONSIDERATIONS

Detailed considerations for Eksportfinans's currently assigned ratings are as follows:

Franchise Value

Trend: Neutral

Eksportfinans focuses on export-related financing, amounting to NOK78 billion at end-Q3 2009. The loan book, which is being transferred to KLP within a two-year period, totalled NOK34 billion at end-Q3 2009. Eksportfinans's position as an important provider of export financing is emphasised by the government's decision to provide it with funding and thus support the competitiveness of the export sector, which is highly important for the Norwegian economy.

Eksportfinans has an unchallenged monopoly in providing government-supported export finance (the 108 Agreement) for capital goods and services as well as for ships in Norway, and a preferred co-operation position and consequent good franchise in export lending for its other shareholders - major Norwegian banks. In export loans, Eksportfinans is co-operating with Norwegian and some international banks to provide attractive financing packages to customers.

Importantly, Eksportfinans has no intention of moving towards commercial banking activities. To do so would affect its position as a specialised institution - the basis for the regulatory authorities allowing commercial banks to have a stake in Eksportfinans - and put it in direct competition with its shareholders.

Eksportfinans's earnings stability is influenced by its export lending activities, which we regard as a less stable earnings source than retail or public sector lending given that the export sector is more exposed to cyclicality. After the sale of Kommunekreditt, Eksportfinans will be dependent on a single business line, which could make it more vulnerable to changes in market dynamics. In addition, the large liquidity portfolio has caused volatility in earnings, although since March 2008 this has been offset by the portfolio hedge agreement. Also, fluctuation in the fair value of the institution's own debt has resulted in fluctuation in reported earnings.

Risk Positioning

Trend: Neutral

The two largest banking groups in Norway are the main owners of Eksportfinans: DnB NOR holds 40% of shares and Nordea Bank Norge 23%. The government has a 15% ownership stake, which it acquired in 2001 to underline the importance of Eksportfinans's role in and services to Norway's economy. The government also has an indirect holding in Eksportfinans through its 34% stake in DnB NOR. The other owners are smaller Norwegian commercial and savings banks and Danske Bank, which became an owner after it acquired Fokus Bank.

We understand that, due to its important role supporting the Norwegian export industries, the government's intention is to maintain its co-ownership, but Eksportfinans does not benefit from a guarantee from the government. We also note that the government is supporting Eksportfinans in terms of funding for qualifying export projects for a two-year period until the end of 2010. In addition, the government has changed the ownership classification to a higher category 3 from a category 1, which reflects that in addition to commercial objectives the entity also has other specifically defined objectives as a lender to the Norwegian export sector. The government-owned local government lender Kommunalbanken is also placed in category 3.

Eksportfinans follows the Norwegian code of practice for corporate governance. The board of directors consists of eight members, four of whom represent the owner banks (the three-largest owner banks, DnB NOR, Nordea and Danske Bank, are represented). The CEO is not a member of the board. In our view, the institution does not face "key-man" risk. We do not have concerns about Eksportfinans's corporate governance.

Eksportfinans has been re-evaluating its risk management framework. We are following the process closely and have seen actions taken in terms of increased focus on risk management and the strengthening of the risk management function.

As regards credit risk, Eksportfinans's loan portfolio exhibits considerable single-name and industry concentration, reflecting its niche operating areas. These risks are, however, mitigated by the fact that the largest exposures to the corporate sector are guaranteed by sovereign or highly rated financial institutions. The largest counterparties are the Kingdom of Norway (through GIEK, the Norwegian Government Guarantee Agency) and DnB NOR Bank. The largest direct exposure to any counterparty was 38% of equity at year-end 2008. Credit risk exposure to financial institutions is mainly limited to ratings of at least A3 and to entities in the EU and/or OECD. In addition, Eksportfinans has some exposure to banks that are not internationally rated - mainly Norwegian. Ship-related loans represent the largest concentration, accounting for 26% of the loan portfolio at end-September 2009. This exposure more than doubled in 2007 and increased by over 60% in 2008, reflecting the favourable terms of the government-supported lending scheme. However, in the first three months of 2008, the growth in ship-related loans slowed to 2% from end-2008. We also note that, given the low interest rate environment, fewer borrowers have been using the government-supported scheme,

which is for fixed interest rates.

A significant risk relates to structured funding, since fluctuations in currencies, interest rates, equity prices, credit spreads and commodity prices can affect the maturity of the issued bonds. However, market risk in these instruments is swapped back to back and market risk left to Eksportfinans is only related to the libor interest rate. In general, the swaps transform market risk to liquidity risk since around 60% of structured funding (i.e. 40% of total funding) is callable or has triggers. Eksportfinans will call the bond issue if the swap is terminated.

To manage this risk, Eksportfinans has developed a proprietary tool to model the expected maturity of structured funding. The total currency exposure and interest rate risk have been limited by the board and the positions have remained well below the limits in the past few years, although the interest rate risk has increased since year-end 2006. The limit for the net currency position is NOK120,000 in relation to a one-basis-point movement in any foreign currency and also for the total value of the currency position. At year-end 2008, the net currency position was NOK31 million (0.8% of Tier 1 capital). The limit for interest rate risk has been lowered to NOK300,000 from NOK700,000 in relation to a one-basis-point movement in interest rates.

For managing the liquidity, Eksportfinans holds a sizeable securities portfolio, representing 34% of total assets as of end-September 2009. The "old" liquidity portfolio has been classified as "held for trading" and therefore is subject to mark-to-market valuation despite the institution's intention to hold these assets until maturity. This portfolio is, however, covered by the portfolio hedge agreement up to NOK5 billion of losses. The portfolio consists of senior financials (59%) with an average rating of A1 and asset-backed securities (ABS, 41%) with an average rating of Aaa at end-Q3 2009. The majority of ABS investments are in Europe and in RMBS - less than 10% is in US securities and there is no direct sub-prime exposure.

To eliminate the earnings volatility resulting from the "old" liquidity portfolio, Eksportfinans entered into a portfolio hedge agreement with its owner banks effective from 1 March 2008. The portfolio hedge agreement offsets losses of up to NOK5 billion (as of end-September 2009, around 23% had been used) as well as any gains in the portfolio held as of 29 February 2008 and valued at approximately NOK70 billion. Since then, Eksportfinans has mainly made new investments in short-term European financial papers.

The importance of good liquidity management is underlined by Eksportfinans's reliance on market funding and therefore we expect to see more prudent asset-liability management as regards the matching of funding and lending maturities. We note that liquidity management has been emphasised in the recently revised risk management policy. The institution has decided to place greater focus on the liquidity of the liquidity reserve portfolio, which should provide a buffer in the event of disrupted access to market funding. Overall, our concerns are related to structured investments since these instruments have proven less liquid during periods of financial stress. In the revised risk management policy, the board of directors has limited the proportion of ABS investments to a maximum of 20%. We will follow the performance of the revised investment strategy closely.

We positively note a well-diversified funding base in terms of maturities and investors. Eksportfinans has had access to the market and has also re-entered to the benchmark market in H2 2009 with issues in Swiss francs and US dollars. Funding from the government has been helpful, although we note that it is temporary and in place until end-2010.

#### Regulatory Environment

Eksportfinans is subject to supervision by Kredittsynet, the Norwegian financial supervisory authority. For a discussion of the regulatory environment, please refer to Moody's Banking System Outlook on Norway.

#### Operating Environment

When looking at the operating environment of a country, we consider economic stability, the level of integrity and corruption, and the legal system. In the case of Norway, mainland GDP is used as a proxy for economic stability, reflecting the segregation of oil income from the public finances that has been in place for the past decade. We note that the operating environment for the export sector in Norway has become more challenging due to the global economic slowdown, although there are some signs of stabilisation.

#### Profitability

Trend: Neutral

Like specialised lenders, Eksportfinans has low core profitability due to low margin lending. However, it has been able to improve net interest margin significantly reflecting increased lending margins, the higher volume of export lending and higher income from the securities portfolio - net interest margin on average earning assets increased to 0.66% in January-September 2009 from 0.47% in 2008 and around 0.30% in 2005-2007. In 2007 and 2008, loan growth was strong, but in the first nine months of 2009, loans to ships, capital goods and export-related and other international activities decreased by 3% from end-2008.

The loan growth in 2008 was mainly related to strong demand from shipping and capital goods sectors. In the local government sector, Eksportfinans has been raising margins due to higher funding costs, which led to a 14% decrease in Kommunekreditt's loan book in 2008. Net interest margin on local government lending was 0.35% in 2008 compared with 0.20% in 2007. Kommunekreditt's loan book, amounting to NOK34 billion at end-September 2009, will be transferred to KLP over a two-year period and Eksportfinans will keep around NOK11 billion of Kommunekreditt's loans in its own books. We also note that margins under the government-supported scheme, the 108 Agreement, were reduced for larger loans in 2007. Recently, the volume growth in the 108 loans has been weaker as the borrowers have favoured commercial loans with floating rates. Some of these loans are 0% risk-weighted.

Eksportfinans has experienced significant volatility in its earnings due to the mark-to-market valuation of its own debt. In the first nine months of 2009, the entity reported an unrealised loss on NOK2.9 billion due to the tightening of credit spreads, whereas in 2008 there was a significant positive impact. In comparison, the net result for 2007 was negative due to the weak performance of the liquidity portfolio, resulting in large unrealised losses. The earnings volatility related to the securities holdings is now mitigated by the portfolio hedge agreement. Eksportfinans pays a monthly fee of NOK5 million for the portfolio hedge provided by the owner banks, which will cover losses of up to NOK5 billion.

Eksportfinans has been able to improve its lending margins significantly, but once the market conditions and competitive landscape normalise there is likely to be less room for improvement. In addition, we note that the increase in net interest income has also been driven by a higher return on the securities portfolio, accounting for 45% of total net interest income in January-September 2009. Market volatility continues to affect the result given the mark-to-market valuation of the entity's own debt. Additionally, loan growth could be affected if the global economic slowdown

and weak growth in the order books of Norwegian export companies continue.

#### Liquidity

Trend: Neutral

Eksportfinans relies totally on market funding and is not allowed to collect deposits. The most important funding source is bond debt, which represents over 80% of issued debt securities. Long-term bonds can be issued under euro-, US dollar- or Australian dollar-denominated medium-term note programmes and the Japanese debt shelf programme. For the issuance of structured bonds, Eksportfinans is also using a proprietary web-based tool, eFunding.

Long-term issues include plain vanilla and structured issues, which are especially popular among Japanese investors. Structured issues increased faster than plain vanilla issues during 2008. We note that around 60% of structured funding (i.e. 40% of total funding) has features (call options or triggers) that might shorten the maturity of these issues and could affect liquidity. Eksportfinans has been active in private placements, especially in the Japanese and US markets and has also issued three benchmark bonds in H2 2009. For short-term funding, Eksportfinans has in place USCP and ECP programmes, both amounting to US\$6 billion. As regards to the USCP programme, we note that the entity has a repo facility in place.

Eksportfinans has a large securities portfolio, representing 34% of total assets at end-September 2009, and including highly rated securities. Regarding the liquidity portfolio under the portfolio hedge agreement (NOK66 billion or around 70% of total securities on the balance sheet), we have some concerns about the high proportion of structured securities (around 40% of the liquidity portfolio), which have proved less liquid in financial stress events. In the current market conditions, there are still uncertainties related to the value of the portfolio. It should be noted that, despite the portfolio hedge agreement, the liquidity portfolio can be used in repo transactions with banks - Eksportfinans has committed repo facilities from its three-largest owner banks amounting to US\$4 billion with a current maturity of Q2 2010. Eksportfinans has indirect access to the Central Bank of Norway via a Norwegian bank.

In addition to the liquidity portfolio under the portfolio hedge agreement, Eksportfinans has set up a new liquidity reserve portfolio, which consists of short-term papers of financial institutions; the spread duration currently being less than three months.

#### Capital Adequacy

Trend: Neutral

Thanks to a capital injection of NOK1.2 billion by the shareholders, which was paid in March 2008, Eksportfinans's capitalisation improved in 2008. Prior to the capital increase, the Tier 1 ratio had dropped to 6.3% at year-end 2007 due to the negative mark-to-market valuation of the securities portfolio. Eksportfinans did not pay out a dividend in 2007 or 2008.

At end-September 2009, the Tier 1 ratio was 9.8% and the total capital ratio was 13.5%.

The portfolio hedge agreement has limited the deterioration in capital adequacy. We also note that changes in the fair value of the entity's debt do not have material impact on its equity. Eksportfinans's target is to keep the Tier 1 ratio at around 8%. Core capital included hybrid capital amounting to NOK506 million (£50 million) at year-end 2008.

For Basel II purposes, Eksportfinans is using the standardised approach to assess credit risk. It should be noted that, in Norway, loans to local government and municipalities carry a risk-weight of 20%, whereas in Europe in general the risk-weight is zero. At end-September 2009, the average risk-weight calculated on total assets was 16%.

#### Efficiency

Trend: Neutral

Eksportfinans's cost efficiency has been relatively good over the years. Operating costs in relation to assets were 0.07% in January-September 2009 compared with 0.08% in 2008, 0.10% in 2007 and 0.11% in 2006. For Kommunalbanken, the comparable figures were below 0.10%. As such, maintaining a low cost base and access to competitive funding are vital for Eksportfinans due to the low lending margins.

Among Eksportfinans's key challenges is its capacity to demonstrate, both to its key shareholders and to the Norwegian authorities, that it provides the most efficient means for export financing in Norway.

#### Asset Quality

Trend: Neutral

The asset quality of Eksportfinans's loan book has historically been very strong. Good loan quality reflects the fact that most of the export lending is guaranteed by the banks and/or the Norwegian government (through GIEK). Guarantees from GIEK cover political risks at 100% and the maximum cover for commercial risks is 90%. At end-September 2009, GIEK guarantees covered 22% of the export loan portfolio. In general, the bank guarantors are highly rated - the five largest guarantors are rated in the range of Aa3-Aaa. However, we note that in general, export lending has a weaker risk profile than local government lending in Norway.

In 2009, problem loans (interest and principal and not matured principal on loans over 90 days past due) have increased significantly and accounted for 0.9% of gross loans at end-September 2009 - this is mainly related to the exposure towards Icelandic banks, which we do not consider to be guaranteed in a satisfactory manner. In H2 2008, Eksportfinans reported provisions regarding an Icelandic bank that had acted as an agent and guarantor for several loans due to a breach of its obligations. In addition, the entity is engaged in a syndicated exposure to Icelandic banks amounting to EUR 10 million at end-2008.

As regards the credit exposure, 5% of the loan portfolio was to local governments, 28% to Kommunekreditt AS, 17% was to the central governments, 36% was to Norwegian bank guarantors and 15% was to international bank guarantors at end-June 2009. As a result of the sale of Kommunekreditt, the loan book of Eksportfinans decreased to NOK64 billion at end-Q3 2009 from NOK113 billion at year-end 2008. In addition, loans to credit institutions amounted to NOK26 billion at end-Q3 2009. Last year, the lending growth was driven by the booming maritime industry, although the outlook is now weaker. Disbursements under the government-supported scheme for export lending have decreased

significantly due to less favourable terms (fixed CIRR interest rate).

With respect to the asset quality of the loan book, we take comfort from the good credit quality of the guarantors and the solid local government sector in Norway, but caution that there could be losses in relation to the Icelandic exposure (although we note that the bank has provisioned a significant amount of potential losses).



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