REQUEST FOR COMMENT

Approach to Determining the Issuer Anchor Point for Covered Bonds

Summary

In this Request for Comment (RFC), we propose an adjustment to the anchor point we use in our covered bond analysis as a proxy for the probability of the issuer ceasing to make payments to covered bondholders. This RFC follows the agreement that the EU Council and ECOFIN reached on 27 June 2013 on a draft of the proposed European Union (EU) directive on bank resolution (the Directive). The Directive calls for the resolution of bank failures through the bail-in of unsecured bank debt and certain deposits, while explicitly exempting covered bonds, from the bail-in process. The EU Council’s agreement marks a milestone in the evolution of EU policy and has provided sufficient certainty for us to propose to amend our approach, aligning it with the Directive’s provisions.

The potential credit benefits to covered bonds that will derive from the Directive’s implementation will depend upon the amount of bail-in-able debt. We propose to translate that credit benefit into our covered bond ratings by modifying the covered bond anchor point. This is the reference rating for covered bonds before the benefits from collateral are considered, currently the issuer’s senior unsecured rating (SUR)3 – to equal the higher of (a) the adjusted BCA4 plus up to two notches or (b) the SUR plus up to one notch (with certain exceptions). The amount of uplift will vary with the amount of bail-in-able debt available. Furthermore, whether we choose the BCA or SUR as starting points will also depend upon the number of notches of extraordinary government support we assume when assigning the bank’s unsecured debt rating. This approach would be applied in the EU and would perhaps eventually be extended to other jurisdictions that contemplate similar bail-in measures for unsecured debt while protecting covered bonds.

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1 The anchor point refers to the rating level corresponding to the probability that the issuer (or another entity in the issuer group that supports the issuer) ceases to service the debt obligations under the covered bonds.

2 ECOFIN is the Economic and Financial Affairs Council, which is composed of the Economics and Finance Ministers of the EU member states.

3 With some exceptions: (a) in some cases the issuer is not rated. It may be a specialist issuing entity, or affiliate, supported by a rated entity, and we use the latter’s rating as the anchor; (b) in some cases we use the issuer’s deposit rating as the anchor rather than its senior unsecured rating. For the purposes of this RFC we do not distinguish between the deposit rating and senior unsecured rating.

4 The BCA (Baseline Credit Assessment) reflects our opinion of a bank’s intrinsic, or standalone, financial strength relative to all other rated banks globally. The adjusted BCA incorporates support from a parent (operating company or family group). For further information on BCA/adjusted BCA please refer to our bank rating methodology (Global Banks, Moody’s Rating Methodology, May 2013).
The addition of the adjusted BCA as an anchor point for our covered bond analysis represents a significant evolution in our thinking because, thus far, we have in almost all cases used the SUR. We propose adding the adjusted BCA as an anchor point as it allows us to determine the benefit to covered bondholders provided by the “internal support” of the bail-in aspect of the Directive. However we still maintain the SUR as an anchor point to capture situations in which “external support” may be greater than that implied by bail-in loss absorbing capacity.

The adjustment proposed in this RFC is a deliberately intended to be a conservative assessment of the credit benefits to covered bonds implied by the Directive because it is not expected to come into effect for some years (although we expect national regulators to apply its principles where practicable earlier than then) and there remain many uncertainties around various aspects of future implementation. This proposal should therefore be seen as an initial step in incorporating the implications of the Directive into our rating methodologies, and we will refine our analysis as more certainty emerges on how regulators will implement and apply the Directive.

Overall, we expect that the rating impact of our proposed change to the anchor point will be that the majority of European covered bonds not currently rated at the sovereign ceiling or Aaa could be upgraded by a notch or two.

Please note that this RFC is not intended as a stand-alone methodology, and should be read in conjunction with our rating methodology for covered bonds (Moody’s Approach to Rating Covered Bonds, Moody’s Rating Methodology, July 2012).

In addition to broader comments about the proposals contained within this RFC, we seek comments specifically on:

1) Are the proposed levels of bail-in-able debt appropriate to achieve 1-2 notches of uplift?

2) Should we consider uplift beyond +2 notches above the adjusted BCA and/or +1 notches above the SUR?

3) Should the number of notches for external support and loss absorbing capacity due to bail-in be strictly additive, or should we assume some tradeoff between the two: for example, limiting credit for bail-in-able debt when we have assumed a high degree of support in the SUR?

We ask that market participants respond to this RFC within one month of its publication date. After this deadline has passed, we will take account of the comments and propose definitive changes to our covered bond methodology. Please send comments to RFC@moodys.com using the RFC Response Form available on the RFC Topic Page on www.moodys.com.
Key Considerations

We expect that EU member states will adopt the Directive and that the proposals for covered bonds will be largely credit positive. The Directive pointedly excludes covered bonds from any ‘bail-in’ of debt orchestrated as part of the resolution of a troubled bank. The provisions of the Directive increase the probability of the issuer continuing to meet its debt-service obligations to covered bondholders following a senior unsecured default. The Directive remains subject to final negotiations and each EU member still needs to adopt it into national law which may take until 2018. However, thus far, the direction of the legal text is in line with the policy objectives that the EU authorities have maintained throughout the political and legislative process. Consequently, we expect that the relevant clauses from the Directive will substantially be enacted and adopted across EU national jurisdictions.

The covered bond anchor point can now be higher than SUR. The proposed change to our methodology, while maintaining a link between our covered bond ratings and the issuer’s SUR, introduces linkage to the bank’s adjusted BCA and a degree of potential uplift over both reference points. Thus we will now determine rating uplift for the covered bonds under both our EL Model and Timely Payment Indicator (TPI) from a starting point or anchor (which we refer to as the CB anchor) that is the higher of (a) the adjusted BCA plus a positive adjustment of up to two notches, “BCA+[0-2],” and (b) the SUR plus a positive adjustment of up to one notch, “SUR+[0-1].”

Our proposed change will primarily affect those Moody’s-rated programmes with issuers located in EU member states and Norway. We will apply our proposed change in the EU and may extend it to other jurisdictions that contemplate bail-in of unsecured debt while providing clearly for covered bonds to be excluded from any bail-in. As a member of the European Economic Area, Norway is in our view likely to adopt a regime similar to the EU bail-in regime, and we will also apply the proposed change to Norwegian covered bonds from the outset.

Despite increased clarity, the legislation is not yet finalised, with uncertainties on final text and implementation remaining. Notwithstanding the additional clarity that the EU Council’s agreement on the proposed Directive brings, there are significant areas of uncertainty over the Directive’s implications for covered bonds. For example, the EU Council, the European Commission and the European Parliament are yet to agree on the final text of the Directive. We will likely learn more of the full extent of the benefits the Directive might provide covered bonds during the final negotiation phases and as it becomes clearer how regulators propose to implement and apply the Directive. Appendix 2 provides a brief summary of the EU Directive.

As a result our analysis will be refined over time. The adjustment proposed in this RFC should be seen as an initial step. We expect to continue to refine this analysis as we come to understand better how the Directive will be finalised and applied. Furthermore, uncertainty remains about the projected liability structure of the bank at the time of distress as well as the form of resolution of such distress.

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5 The ‘bail-in’ tool gives EU bank supervisors the authority to write down unsecured claims to insolvency values and to convert debt claims to equity to assist a failing institution. See Appendix 2 for further details.

6 The next and final substantive pan-EU stage of the process is the trilogue process, leading to adoption of a definitive text for the Directive.

7 Our covered bond ratings are determined applying a two-step process: first we employ a largely quantitative calculation of expected loss under our Expected Loss Covered Bond Rating Model (EL Model) and we may then cap the rating arrived at using our expected loss method by applying our TPI framework.

8 Our EL Model looks at a covered bond from its date of issue through to its maturity and for each month, calculates the probability of an issuer default and the loss (if any) to the covered bonds following such default. These numbers are multiplied, discounted, and summed and the resulting number gives the expected loss of the covered bond, on which our rating is based.

A TPI measures the likelihood of timely payments to covered bondholders following issuer default and our TPI framework determines the maximum number of rating levels by which a covered bond rating can exceed the reference rating of the underlying issuer.

For further details please see our published methodology Moody’s Approach to Rating Covered Bonds.

8 Or any measure that has an equivalent effect to bail-in. In our analysis we may also consider how well covered bonds are protected from other potentially negative consequences of resolution, such as early termination or partial transfers (see Appendix 2 for further details of Directive protections for covered bonds).
Covered Bonds and Probability of Issuer Default

As long as the issuer does not default, we expect covered bondholders to be paid. Investors in a covered bond benefit from two levels of protection. First they benefit from the issuer’s covenant to pay interest and principal on the covered bonds and management of the assets (the cover pool). Second, if the issuer can no longer make such payments, the bondholders benefit from a priority right over the cover pool. At present, we typically use the SUR of the covered bond issuer as a proxy for the probability of the issuer no longer being able to make payments or manage the pool and covered bondholders are therefore left with recourse to the cover pool. We typically use the SUR as an anchor point to determine:

(a) Under our expected loss analysis (Moody’s EL Model), the probability of the issuer failing to make payments to covered bondholders, and therefore covered bondholders having to rely on support from sources other than the issuer; and

(b) Under our Timely Payment Indicator (TPI) analysis, the anchor rating that determines, in conjunction with the assigned TPI, the maximum achievable covered bond rating.

With the new resolution framework under the Directive this assumption no longer consistently holds true, so we propose to formulate an alternative basis for our measurement of issuer default probability.

The New Covered Bond Anchor Point

We continue to use the issuer’s credit strength as the starting point for our analysis, with the new anchor point being SUR+[0-1], or adjusted BCA+[0-2] if higher. While there appears to be the political will across the EU to avoid resolution actions detrimental to covered bondholders, there is limited additional guidance in the current legislative proposals and limited evidence on which we can base our judgment of where we place the CB anchor. Our proposal, for now, is to locate the CB anchor at the higher of SUR+[0-1] or adjusted BCA+[0-2] reflecting, amongst other things, the following considerations:

a) Complete or substantial de-linkage from some measure of issuer credit strength would not be appropriate. If implemented as intended, the new resolution framework will increase the probability of financial institutions either remaining going concerns or going through an orderly wind-down. But it will not remove the possibility of disorderly default and bankruptcy.

b) The resolution framework is new, so there has been no opportunity to test how the framework impacts the degree of linkage between the issuer rating and the covered bonds. As a result we must use our qualitative judgment to assess how the framework will operate and the resulting impact on the linkage between issuer and covered bond ratings. We propose to maintain the existing linkage to the SUR, but add an alternative linkage, to the adjusted BCA. Two anchor reference points allow analytical flexibility in the current environment, where support for covered bonds might be derived either from public sources (the probability of which is reflected in the SUR) or via the bail-in of unsecured creditors (reflected in the notching above the BCA).

c) Linkage to the adjusted BCA. The adjusted BCA reflects the intrinsic, or standalone, financial strength of the issuer, augmented by parental support9, and hence is the most appropriate measure of the probability of a resolution event occurring in relation to the issuer. The addition of up to two notches of uplift over the adjusted BCA is intended to reflect the probability that, even absent

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9 We anticipate in many cases that potential support from a bank’s parent, group or affiliate results in a diminished probability of entering resolution, as measured by our adjusted BCA.
public support, the bail in of senior unsecured debt allows the covered bonds to continue to be serviced as part of a going concern entity.

d) Where driven by adjusted BCA, the degree of uplift over the adjusted BCA will depend on the size of the cushion of bail-in-able debt available to the resolution authorities. The more bail-in-able debt, the greater the likelihood that any covered bond programme continues to be serviced by the issuer in the event of a scenario requiring the use of bail-in.\(^{10}\) Bail-in-able debt is expected to consist primarily of unsecured junior and senior debt securities, although in principle, uninsured deposit liabilities may also be bailed in.\(^{11}\) However, for now we will not include uninsured deposits in our calculation of bail-in-able debt, but we may consider them under (g) below.

e) Where driven by adjusted BCA, CB Anchor expected to be adjusted BCA+2 for issuers with an unsecured senior and subordinated debt/liability ratio of 10% or higher. We have set the CB anchor thresholds for uplift over the adjusted BCA as follows:

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<th>CB anchor assumption</th>
<th>Unsecured senior and subordinated debt / total liabilities</th>
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<tr>
<td>Adjusted BCA + 2</td>
<td>&gt;10%</td>
</tr>
<tr>
<td>Adjusted BCA + 1</td>
<td>5-10%</td>
</tr>
<tr>
<td>Adjusted BCA +0</td>
<td>&lt; 5%</td>
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We believe these are prudent and reasonable base assumptions, based on both the likely size of bank losses that might need to be funded and the potential run-off in unsecured debt prior to a resolution event, pending greater clarity on how the Directive will be implemented and the consequences for secured and unsecured creditors\(^{12}\).

In some cases of substantial additional levels of loss absorbing bail-in-able debt, we may contemplate giving additional uplift over the adjusted BCA.

f) Where driven by SUR, CB Anchor expected to be SUR+1 for most issuers. We have set an alternative CB anchor at SUR+[0-1], where this is higher than BCA+[0-2]. This reflects the fact that, the Directive notwithstanding, many banks have SURs higher than their adjusted BCAs as we believe that at least over the next few years governments may choose to protect senior creditors rather than bail them in. In such cases, the anchor point should still be higher than the SUR because in the event that the government decides not to support a bank, the bail-in-able debt is still available to allow for a continuation of the covered bond programme. The proposal to limit the uplift above the SUR to one notch - if the total cushion of unsecured senior and subordinated debt exceeds 5% - reflects our view that the benefits covered bondholders receive from those two options are not entirely additive, since bail-in is intended to be an alternative to taxpayer support. Regardless of the level of bail-in-able debt, in the small number of cases in which the SUR already incorporates very material levels of government support, we may not give further uplift on the basis that the incremental benefit of potential bail in of unsecured creditors to covered bondholders is low in relation to the benefit derived from likely public support.\(^{13}\)

g) Other qualitative considerations may influence the CB anchor. In addition to considering the amount of bail-in-able debt, there are a number of qualitative factors regulators will consider when

\(^{10}\) Where we believe covered bonds will benefit from aspects of the resolution framework that may not rely on re-capitalisation of the issuer, such as transfer to a third party or placement in an asset management vehicle, we will reflect these possible outcomes in our TPI analysis.

\(^{11}\) Although certain eligible deposits are expected to rank senior to other uninsured deposits and unsecured debt. See, for example, Articles 41 and 99 of the draft Directive.

\(^{12}\) The population of European covered bond issuers benefits on average from a 4% equity cushion which under the Directive will continue to absorb losses ahead of creditors.

\(^{13}\) Note that the government support imbedded in the ratings of certain systematically important banks would benefit senior unsecured debt, as well as covered bonds. The ECOFIN proposal contemplates the possibility that government support might be extended to a bank, but only after at least 8% of its liabilities had already been bailed in. Since this aspect of the Directive is not yet entirely clear, we are not considering this source of potential support for covered bonds at this point in time.
deciding how to treat a bank under resolution. We may further adjust the level of uplift due to such qualitative considerations. For example, we may qualitatively adjust our assumptions on the level of bail-in-able debt if we conclude that uninsured deposits, subject to suitable haircuts, may contribute to a bail-in. Any credit we give for uninsured deposits may depend on factors such as legal and political certainty, expectations around depositor behavior and data sufficiency.

The ratio of senior and subordinated unsecured debt relative to total liabilities determines uplift over the adjusted BCA or SUR. To assess the uplift over the adjusted BCA and SUR, we consider for each issuer the amount of senior and subordinated unsecured debt relative to total liabilities. This ratio provides an estimate of the ability of an entity to absorb losses arising in a bail-in scenario. We exclude equity cushion from the calculation as we are notching off reference points that already include the equity loss absorption capacity in their determination.

We have determined thresholds for uplifts over the adjusted BCA based on an empirical record of losses and government capital infusions around bank failures. We used the available data to determine a median family loss severity which we then qualitatively adjusted to account for uncertainty around the stability of senior and subordinated unsecured debt levels as banks experience distress. To achieve a two-notch uplift above the adjusted BCA, we propose that bail-in-able debt cover the adjusted median loss. This corresponds to a 50% likelihood that the internal support provided by bail-in-able debt is sufficient to cover the shortfall, which in turn maps to a two notch benefit. We then interpolate to determine the cushion required to achieve a one notch uplift.

We may consider the use of other ratios and a potential increase of the maximum uplift as we learn more of how the Directive will be implemented and better understand the full implications of the new regime on secured and unsecured creditors.

On average, the covered bond issuers affected by this methodology change currently show a robust bail-in absorption capacity. Thus, we expect that the majority of covered bonds affected will have uplift over adjusted BCA of +2, with smaller numbers at +1 or 0.

**Rating impact.** The rating impact of the proposal outlined in this RFC will be limited to the subset of covered bond programmes where the covered bond ratings are currently (a) below Aaa; and (b) below the relevant country ceiling. We estimate that the majority of these programmes may be upgraded by one to two notches, in some cases depending upon whether issuers choose to add further over-collateralisation. For those issuers that have limited systemic uplift built into their SURs the covered bonds may benefit by up to two notches, provided the issuer has sufficient bail-in-able debt in place.

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14 This approach draws on several sources of data regarding bank failures including capital injections provided by governments in the EU over the recent crisis as published by the European Commission as well as statistics published in the United States by the Federal Deposit Insurance Corporation since 1986.
Appendix 1: Covered Bond Methodology

Probability of issuer default is a critical component of our Covered Bond methodology. We model our covered bond ratings via a two-step process:

(a) We arrive at a rating for the bond using our expected loss method, employing a largely quantitative calculation of expected loss under our Expected Loss Covered Bond Rating Model (EL Model);

(b) We then apply our TPI Framework that might cap the rating we compute using the EL Model.

Under our EL Model, we calculate the probability of issuer default and the subsequent losses (if any) on the covered bonds. We assume an issuer default on the covered bond means the bondholders must primarily rely on the cash flows generated by the cover pool on a standalone basis. Accordingly, we define issuer default as: a failure by the issuer or another entity (which is normally in the issuer group), to provide support (whether administrative or financial) for the benefit of the covered bondholders.

An issuer default does not necessarily imply a loss or missed payment on the covered bonds. Rather, an issuer default is an interim event that directs our analysis of the covered bond risk away from the issuer (with a primary liability for payment on the bonds) to alternative support mechanisms, including the cover pool.15

15 Hedging swaps may also serve as support for the pool.
Appendix 2: The Directive (EU Council/ECOFIN proposal)

The Directive provided clarity on exclusion of covered bonds from bail-in. The EU Council/ECOFIN met on 27 June 2013 and proposed a new EU Directive on bank resolution (the Directive). Specifically, the Directive provided clarity that covered bonds are excluded from the bail-in tool contained in the Directive. The bail-in, may, however, apply to a bank’s senior unsecured bonds.

Article 38 of the Directive specifies that covered bonds shall not be included in any use of the bail-in tool. Further, there is an option for national authorities to exclude from bail-in any part of the covered bond debt that is not sufficiently collateralised as well as exempt derivatives from bail-in which are used for hedging purposes by covered bond programmes. This flexibility granted to the national regulators is an indication of the intention to keep covered bond programmes fully operational, independent of any bail-in event.

The Directive follows two key objectives:

(a) Avoidance of disorderly defaults by credit institutions; and

(b) Reduction of taxpayer support for failing credit institutions.

Since the financial crisis began, there have been a number of cases of failing banks receiving taxpayer funds while creditors and shareholders have been protected from losses. One reason for this has been the lack of sufficiently flexible legal mechanisms to restructure or transfer constituent parts of institutions, and to impose losses on creditors and shareholders, prior to traditional insolvency proceedings. The Directive provides these mechanisms on a pan-EU basis, subject to implementation by national law.

Unsecured debt is subject to bail-in, leading to a higher probability of a going concern scenario. Under the Directive, the bail-in tool can be applied so that existing creditors and shareholders of an institution can have their investments reduced by up to the amount they would have lost under insolvency proceedings. At the same time, this reduction in liabilities and capital restructuring can provide the foundation for a capital injection that may assist all or part of the institution to continue as a going concern. The result of the Directive, at least for significant credit institutions that are subject to resolution, will be that some form of going concern entity is likely to result following the bail-in of creditors and shareholders.

Covered bonds should benefit. The Directive provides that covered bonds are to be excluded from any use of the bail-in tool. In addition, national authorities have the option to also exclude from a bail-in any part of the covered bond that is not covered by collateral (i.e. effectively unsecured) and also any hedging instrument liabilities that attach to the cover pool. There are also safeguard provisions preventing the use of ancillary powers to terminate or modify certain assets, rights and liabilities. In summary, under the Directive:

(a) Covered bonds cannot be bailed-in;

(b) At the option of national authorities, the un-collateralised portion of a covered bond may not be bailed in;

(c) At the option of national authorities, the hedging instruments protecting covered bond programmes may not be bailed in; and

(d) No part of a covered bond programme may be terminated or modified by the use of ancillary powers, in particular the power to make transfers and interfere with contracts.
The implications of these provisions for covered bonds are that, following the resolution process, covered bonds are likely to remain on the balance sheet of any post-resolution entity, with their nominal value unchanged (at least where they are fully collateralised, which is expected to be the case) and wholly intact in terms of the assets, rights and liabilities comprised in the programme.

This contrasting treatment of covered bonds and unsecured debt under the Directive is the foundation of our proposal to reassess our use of the SUR alone as a direct proxy for the CB anchor.
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