

Erste Bank der oesterreichischen Sparkassen AG

Covered Bonds / Austria

*This pre-sale report addresses the structure and characteristics of the proposed transaction based on the information provided to Moody's as of 31 August 2006. Investors should be aware that certain issues concerning this transaction have yet to be finalised. Upon conclusive review of all documents and legal information as well as any subsequent changes in information, Moody's will endeavour to assign definitive ratings to this transaction. The **definitive** ratings may differ from the **provisional** ratings set forth in this report. Moody's will disseminate the assignment of definitive ratings through its Client Service Desk. This report does not constitute an offer to sell or a solicitation of an offer to buy any securities, and it may not be used or circulated in connection with any such offer or solicitation.*

Estimated Closing Date

[October 2006]

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PROVISIONAL (P) RATINGS

Series	Rating	Amount (million)	% of Notes	Legal Final Maturity	Coupon
[·]	(P)Aaa	CHF[300]	[100.00]	[·]	[·]%
Total		CHF[300]	100.00		

The ratings assigned by Moody's to the Series of bonds address the expected loss in proportion to the Initial class principal amount experienced by investors by the legal final maturity. The ratings address the expected loss posed to investors by the legal final maturity. Moody's ratings address only the credit risks associated with the transaction. Other non-credit risks have not been addressed, but may have a significant effect on yield to investors.

SUMMARY

Moody's has assigned definitive long-term ratings of **Aaa** to the outstanding mortgage *Pfandbriefe* (mortgage covered bonds) issued by Erste Bank der oesterreichischen Sparkassen AG ("Erste Bank" or the "Sponsor Bank") and a provisional rating (P) Aaa to the new proposed series. Erste Bank is the leading bank in the Austrian savings banks sector.

Moody's rating for Erste Bank's mortgage *Pfandbriefe* programme is based on the current issuer rating, the security provided by the pool of assets and the strength of the specific Austrian law (Mortgage Bank Act). Examples of these strengths include the low loan-to-value threshold on mortgages against which *Pfandbriefe* can be issued (just 60%), the additional protection provided by Erste Bank having elected under the act to include in its articles of association a 2% over-collateralisation on a net present value basis, and the further over-collateralisation available over and above the legal requirements. In calculating the Aaa rating, Moody's has factored in over-collateralisation over and above that required by the law.

As is the case with other covered bonds, Moody's considers the transaction to be linked to the rating of the Sponsor Bank (**A1, Prime 1**), in particular from a default probability perspective. Should the Sponsor Bank's credit strength deteriorate, all other things being equal the rating of the *Pfandbriefe* may be expected to be negatively affected. However, Erste Bank has the ability – but not an obligation - to commit voluntary enhancements in the transaction, such as further over-collateralisation in order to increase the de-linkage from its credit strength.



STRENGTHS AND WEAKNESSES WITH MITIGANTS

Strengths

- The mortgage *Pfandbriefe* are issued in accordance with the Mortgage Bank Act,¹ which explicitly protects the status of the note holders. The law stipulates that:
 - Mortgage *Pfandbriefe* are secured by a separated pool of assets (“the Cover Pool”), which are subject to conservative eligibility criteria. In general, only first ranking mortgage loans over Austrian properties and over certain properties located in other member states of the European Economic Area and Switzerland are eligible assets. *Pfandbriefe* can only be issued against 60% of the lending value.
 - A minimum 2% nominal over-collateralisation has to be maintained at all times. The Issuer has elected under the Act to include in its articles of association a requirement to match the Cover Pool and covered bonds in accordance with a net present value (“NPV”) test. Covered bond holders may also benefit from voluntary over-collateralisation in the Cover Pool following the commencement of Sponsor Bank insolvency proceedings.
 - The Cover Pool will be segregated from the Sponsor Bank’s insolvency estate.
 - A special Cover Pool administrator appointed by a court shall undertake the necessary administrative measures to satisfy those claims of the creditors of the *Pfandbriefe*.
 - A Cover Pool monitor (“*Treuhänder*”) will monitor various operations with respect to the Cover Pool.
 - The *Pfandbriefe* are full recourse to the Sponsor Bank.
- The Cover Pool is mainly made up of residential ([25.48]%) and multi-family ([54.47]%) properties. The risk related to these kinds of properties is lower than that observed in other property types.

Weaknesses with Mitigants

- Like most covered bonds, the probability of default of the *Pfandbriefe* is expected to be linked to the probability of Sponsor Bank Default. Reasons for this include:
 - Principal redemption: The duration of the assets may be longer than the duration of the *Pfandbriefe*. Therefore, following Sponsor Bank Default² investors may need to rely on the proceeds from the sale of all or part of the Cover Pool, liquidity borrowing or other form of funding for repayment before final maturity.
 - Liquidity: the Sponsor Bank does not benefit from any designated source of liquidity if cash flow collections are interrupted, which could affect ongoing interest payments or principal redemption of the *Pfandbriefe*.
- **Mitigants:** Moody’s has considered stressed scenarios which include amongst others the sale of the Cover Pool at stressed refinancing margins. Furthermore, the 2% net present value over-collateralisation has to be maintained at all times and the interest yielded of the assets has to be at least as high as that owed to the covered bonds. According to the law, the special Cover Pool administrator is entitled to sell the pool in lots or in full, or to arrange for bridge financing in order to raise liquidity for any possible shortfall.

¹ Mortgage Bank Act (Hypothekendarstellungsgesetz, dRGLB 1899 p. 375)

² Sponsor Bank Default is defined in Moody’s rating methodology for European Covered Bonds as removal from the Cover Pool of (i) support provided by entities within the Issuer/Parent group, (ii) ancillary activities of the Issuer/Parent group (i.e. those not related to the Cover Pool) and (iii) usually, management functions of the Issuer.

- The relatively high concentration on the largest commercial exposures, as the top 20 exposures represent almost 50% of the whole Cover Pool, increases the probability of high defaults. **Mitigants:** only up to the first 60% of the lending mortgage value may be used as assets in the Cover Pool, and therefore should any borrower default the severity of loss should be limited. In addition, Moody's analysis has considered this concentration when calculating the possible losses in the Cover Pool upon Sponsor Bank Default. This has been incorporated in the over-collateralisation level.
- Currently there exists no perfect matching between assets and liabilities in respect of currency risk. **Mitigant:** this risk is covered by the level of over-collateralisation.
- As in many covered bond frameworks in Europe, there are few restrictions or limitations on the future composition of the Cover Pool. This may have the effect of creating substitution risk for the Cover Pool. **Mitigants:** (i) the low LTV threshold on mortgages against which *Pfandbriefe* can be issued (just 60%); (ii) Erste Bank has stated its intention to remove any loan from the Cover Pool which is provisioned or in foreclosure proceedings on a monthly basis; and (iii) the pool composition will be monitored. If the quality of the collateral deteriorates below a certain threshold, the Sponsor Bank would have the ability, but not the obligation, to increase the over-collateralisation in the Cover Pool. If additional over-collateralisation is not added following a marked deterioration of the collateral, this could lead to a negative rating action.

STRUCTURAL AND LEGAL ASPECTS

Erste Bank issues mortgage covered bonds in accordance with the Austrian Mortgage Bank Act

The Sponsor Bank has established a Mortgage Covered Bond programme according to the amended Austrian Mortgage Bank Act enacted on 1 June 2005, under which mortgage *Pfandbriefe* will be issued from time to time, in each case constituting direct, unconditional and senior obligations of the Sponsor Bank.

Moody's understanding from legal and industry advisors is that some of the key characteristics of the Austrian Mortgage Bank Act include the following:

At Sponsor Bank Default the Cover Pool administrator may take over management responsibility of the programme

- The Cover Pool is made up of predominantly first lien mortgage loans secured by residential or commercial properties located in Austria or other Member States of the European Economic Area or Switzerland.
- Substituted assets are allowed up to 15% over the outstanding *Pfandbriefe*. Such assets may be cash held on a separate account, or deposits with a central bank or with certain credit institutions in OECD states.
- A special administrator shall undertake the necessary administrative measures to satisfy claims by the creditors of the covered bank bonds by collecting claims that are due, selling individual cover assets or organising bridge financing. Having an independent Cover Pool administrator may reduce potential conflicts of interest between the *Pfandbriefe* investors and other creditors. Moody's is of the opinion that the party providing bridge financing would enjoy pari-passu status with the covered bond holders. While the Act does not contain any specific limitation to such effect, we believe that granting security in individual assets of the Cover Pool to the liquidity provider would not be compatible with the concept of the Act, which is based on the principle of equal treatment of covered bond holders and pari-passu creditors.
- If feasible, the Cover Pool, as well as all obligations under the covered *Pfandbriefe* (and the obligations vis-à-vis pari-passu creditors, such as hedge counterparties or liquidity providers) are to be transferred to a suitable credit institution, which becomes liable for the claims of the covered bond holders and pari-passu creditors. If the issuer has opted for an early redemption at present value in its articles, and if there is sufficient cover, the Cover Pool will not be transferred but the claims of the covered bond holders (and pari-passu creditors) will be redeemed early at the then current NPV. Erste Bank has not opted for this latter alternative.
- Legal over-collateralisation is enshrined by law. A minimum 2% nominal over-collateralisation has to be maintained at all times. The Issuer has elected under the Act to include in its articles of association a requirement to match the Cover Pool and covered bonds in accordance with a NPV test.
- Covered bond holders may benefit from voluntary and prescribed over-collateralisation in the Cover Pool following the commencement of Issuer insolvency proceedings. Only those assets clearly not necessary to cover the claims of the creditors of the *Pfandbriefe*, the over-collateralisation amount as per §6.1 and the costs of the separate estate shall be surrendered to the general bankruptcy estate.
- Derivatives in the Cover Pool rank equally with covered bond investors. To date Erste Bank has not entered any swap into the Cover Pool register.

Having an independent Cover Pool administrator may reduce potential conflict of interest between the Pfandbriefe investors and other creditors

MOODY'S RATING METHODOLOGY

Moody's Special Report regarding its rating approach to covered bonds³ details the approach used for rating covered bond transactions. The impact of the credit strength of the sponsor bank, quality of the collateral, refinancing and market risks are considered below.

³ Moody's Rating Approach to European Covered Bonds dated 13 June 2005

Erste Bank is the leading bank in the Austrian savings banks sector and has extended its activities in Central and Eastern Europe

The assets in the Cover Pool will initially predominantly consist of Austrian mortgage loans

1) Credit Strength of the Sponsor Bank

The Pfandbriefe are full recourse to Erste Bank (A1, Prime-1). Erste Bank is the leading bank in the Austrian savings banks sector. It is also a leading retail bank in Central and Eastern Europe, where it serves more than 15 million customers. The ratings reflect the bank's good financial fundamentals and solid position in the Austrian retail and SME market, and are underpinned by the closer integration of the Austrian savings banks, for which Erste Bank acts as the central service provider. These ties enhance Erste Bank's domestic franchise and financial strength, notably through the consolidation of the savings banks' results and the solid capital in its own financial statements.

For more information on the fundamental credit quality of Erste Bank, see Moody's opinion updates and credit opinion (last updated 14 July 2006).

2) Quality of the Collateral

As of August 2006, the Cover Pool comprised [2,283] loans for a total amount of €606 million, and enjoyed a nominal over-collateralisation of approximately 19.38% after the proposed issue. In our analysis Moody's did rely on over-collateralisation over and above that provided for by the Austrian Mortgage Bank Act. Moody's notes that should the Sponsor Bank be downgraded below A3, Moody's would remove the benefit from its analysis of any over-collateralisation that was not "committed".

The Cover Pool is made up of approximately of [25.48]% residential mortgage loans and [74.52]% commercial mortgage loans, with multi-family the dominant asset type (approximately 72% over the commercial portion). No substituted asset was registered in the Cover Pool as of the report date.

The credit quality of the Cover Pool as of the end of August 2006 is evidenced by, amongst other characteristics, the first lien position of almost all mortgage loans and the legal limitation of including loans only up to the first 60% of the lending value of the property in the Cover Pool. In addition, Erste Bank has stated its intention to remove any loan from the Cover Pool which is provisioned or in foreclosure proceedings.

As of August 2006, the residential portion of the Cover Pool had the following features:

Table 1:

€ denominated residential mortgage loans

Current Balance (million):	80.18	Average current LTV in %:	61.20
Number of Loan parts:	1,218	Fixed rate assets:	30.52%
Number of Borrowers:	547	Average seasoning in years::	8.32
Number of Properties:	2,121	Average remaining terms in years:	10.80
Average Loan (Borrower):	65,833	Main regional concentration:	Vienna (53.44%), Lower-Austria (35.11%)

Table 2:

CHF denominated residential mortgage loans

Current Balance (in € million):	74.25	Average current LTV in %:	89.64
Number of Loan parts:	308	Fixed rate assets:	7.50%
Number of Borrowers:	348	Average seasoning in years::	2.79
Number of Properties:	829	Average remaining terms in years:	17.50
Average Loan (Borrower):	241,060	Main regional concentration:	Vienna (53.42%), Lower-Austria (41.41%)

From a credit perspective, Moody's sees the following characteristics of the residential portion as positive:

- All properties securing the outstanding loans are constructed.
- The relative low LTV (61.20%) by those Euro denominated loans.
- The attractive economy of the area of Vienna.

From a credit perspective, Moody's sees the following portfolio characteristics as negative:

- The relative high LTV [89.64]% of CHF denominated loans, which results in a higher expected default frequency and more severe expected losses.
- In addition, CHF loans may incorporate an additional currency risk to Austrian borrowers, which could increase the propensity to default.

The above factors have been incorporated into Moody's analysis. Moody's calculates a Collateral Score based on the characteristics of the residential loan pool using a scoring model in order to assess the credit quality of this portion of the Cover Pool.

As of August 2006, the commercial portion of the Cover Pool had the following features:

Table 3:

€ denominated commercial mortgage loans

Current Balance (million):	395.74	Average current LTV in %:	56.27
Number of Loan parts:	610	Fixed rate assets:	26.69%
Number of Borrowers:	276	Average seasoning in years:	10.65
Number of Properties:	1,528	Average remaining terms in years:	15.78
Main property type:	Multifamily (76.84%), Retail (19.66%)	Main regional concentration:	Vienna (74.49%), Lower-Austria (15.20%)

Table 4:

CHF denominated commercial mortgage loans

Current Balance (in € million):	56.01	Average current LTV in %:	71.09
Number of Loan parts:	147	Fixed rate assets:	20.10%
Number of Borrowers:	103	Average seasoning in years:	3.21
Number of Properties:	813	Average remaining terms in years:	14.64
Main property type:	Retail (45.29%), Multifamily (31.27%)	Main regional concentration:	Lower-Austria (50.00%), Vienna (44.42%)

From a credit perspective, Moody's sees the following characteristics of the commercial portion as positive:

- The high percentage of multi-family properties [71.18]%.
– Approximately 75% of all real estate developers renting multi-families are limited-profit housing associations ("HAs" or *Gemeinnützige Bauvereinigungen*), i.e. 55% over the whole commercial portfolio. HAs are highly regulated entities which play a key social role in the Austrian housing system, accounting for almost 30% of new residential construction and receiving approximately one third of all government aid in Austria for the purposes of residential construction and renovation. Most of them are co-operatives, or are owned by municipalities or local governments.
- Most of the HAs in the Cover Pool are located in Vienna, the most dynamic economic area in Austria, which has projected population increases over the short to medium term.

From a credit perspective, Moody's sees the following portfolio characteristics as negative:

- The relatively low diversification of the commercial portion. The top 20 major exposures represent approximately 70% of the commercial pool, which increases the volatility in losses.

The above factors have been incorporated into Moody's analysis. Moody's calculates a Collateral Score based on the characteristics of the commercial portion of the pool using a Monte Carlo simulation approach in order to assess the credit quality of this portion of the Cover Pool.

The majority of commercial loans are made against multi-family properties

As with most covered bonds in Europe, there are few restrictions or limitations on the future composition of the Cover Pool. This may have the effect of creating substitution risk.

Substitution risk is mitigated by the strength of the Austrian Mortgage Bank Act

Mitigants to substitution risk which should protect the quality of the Cover Pool over time include:

1. The low LTV threshold on mortgages against which *Pfandbriefe* can be issued (just 60%);
2. Erste Bank has stated its intention to remove any loan from the Cover Pool which is provisioned or in foreclosure proceedings; and
3. The pool composition will be monitored. If the quality of the collateral deteriorates below a certain threshold, the Sponsor Bank would have the ability, but not the obligation, to increase the over-collateralisation in the Cover Pool. If additional over-collateralisation is not added following a marked deterioration of the collateral, this could lead to a negative rating action.

3) Refinancing the Cover Pool

Lower refinancing stresses due to higher level of multi-families

Where the “natural” amortisation of the Cover Pool assets alone cannot be relied on to repay the principal, Moody’s assumes that funds must be raised against the Cover Pool at a discount. Due to the high level of multi-families in the Cover Pool, in the modelling of this transaction Moody’s has used refinancing margins which are relatively low compared with those of other commercial portfolios. Other standard assumptions have been applied regarding refinancing margins following Moody’s approach.

4) Market Risk

No perfect matching of currencies has been considered in the analysis

Currently there exists no perfect matching between assets and liabilities in respect of currency risk. Although it is expected that Erste Bank will balance the amounts of CHF denominated assets and liabilities, Moody’s analysis has not considered that currency risk will be fully mitigated in this way, as different payment profiles and maturities will lead to either CHF proceeds being collected before or after the corresponding liabilities are owed, or upon the refinancing of the *Pfandbriefe*, more euro or CHF liabilities should be redeemed as compared to the outstanding CHF assets to be realised.

As with the majority of covered bonds, there is potential for interest rate risk. Following Sponsor Bank Default, *Pfandbriefe* investors may be exposed to interest risk, which may arise from the different payment promises and durations made on the Cover Pool and the *Pfandbriefe*. Following Sponsor Bank Default, Moody’s covered bond model looks separately at the impact of increasing and decreasing interest rates on the expected loss of the *Pfandbriefe*, and takes the path of interest rates that leads to the worst result.

The exposure to interest rates movements is mitigated by the 2% net present value test

To date, Erste Bank has not entered into any swaps that qualify for the Cover Pool register. However, interest rate risk is partially mitigated by the 2% over-collateralisation based on the “stressed” net present value calculation opted for by Erste Bank under its Articles of Association. This internal approach stresses interest rates by applying 10bps key rate shocks of every term point extrapolated to a 100bps shock.

Moody’s does not currently assume that the special Cover Pool administrator will always be able to efficiently manage any natural hedge between the Cover Pool and the covered bonds.

DE-LINKAGE AND RATING SENSITIVITY TO ERSTE BANK

The creditworthiness of the Pfandbriefe will be impacted by the credit strength of the Sponsor Bank and the Cover Pool

All covered bonds have an element of rating linkage to a) the transaction counterparties and b) the supporting collateral. In other words, the creditworthiness of the *Pfandbriefe* will be affected by the credit strength of the transaction counterparties and the value of the Cover Pool.

There are a number of other areas of linkage that affect most covered bond transactions, including:

- Refinancing risk. Following Sponsor Bank Default, if principal receipts from collections of the Cover Pool are not sufficient to meet the principal payment on a *Pfandbrief*, funds may need to be raised against the Cover Pool. However, the fact that the Sponsor Bank has defaulted may negatively impact the ability to raise funds against the Cover Pool.

- The dynamic nature of the transaction up until Sponsor Bank Default. For example, up to Sponsor Bank Default, new assets may be added to the Cover Pool, new bonds issued and new hedging arrangements entered into.
- More generally, by the incorporation of the credit strength of the Sponsor Bank in Moody's rating method.

The probability of default on the *Pfandbriefe* may be higher than expected for Aaa rated senior unsecured debt. However, Moody's primary rating target is the expected loss, which also takes severity into account. In this case this is consistent with an Aaa rating. Furthermore, the *Pfandbriefe* will come under increasingly greater rating stress as the Sponsor Bank's credit strength deteriorates. This is a consequence of the linkage of the transaction to the probability of default of the Sponsor Bank.

The following are selected features of the *Pfandbriefe* that reduce the linkage of the covered bonds to the credit strength of the various transaction parties and the collateral:

Mitigants to linkage to the collateral include:

- The legal nominal matching cover test and the requirement to hold 2% over-collateralisation on a "stressed" net present value basis;
- The low LTV threshold on mortgages against which *Pfandbriefe* can be issued (just 60%);
- Erste Bank's stated intention to remove any loan from the Cover Pool which is provisioned or in foreclosure proceedings; and
- The pool composition will be monitored. If the quality of the collateral deteriorates below a certain threshold, Erste Bank would have the ability, but not the obligation, to increase the over-collateralisation in the Cover Pool.

The provisions above should mean there is substantial value in the Cover Pool at the time of Sponsor Bank Default.

Mitigants to linkage to Erste Bank include:

From an expected loss perspective:

1. the quality of the Cover Pool at time of Sponsor Bank Default (see above);
2. the segregation of the Cover Pool from the insolvency estate of the Sponsor Bank.

From a timeliness of payment perspective:

The level of support that the Austrian legislation provides to mitigate any delay of payments on the *Pfandbriefe* following a Sponsor Bank Default. These include:

1. The Austrian Mortgage Bank Act offers a variety of ways in which financing can be achieved against the Cover Pool, including complete and partial sales of the Cover Pool and raising liquidity;
2. A special Cover Pool administrator may take over management responsibility of the programme before Sponsor Bank Default.
3. The special Cover Pool administrator acts independently of the insolvency administrator of the Sponsor Bank, and his duty of care is to the *Pfandbriefe* investors. Having an independent Cover Pool administrator may reduce potential conflicts of interest between the *Pfandbriefe* investors and other creditors.

MONITORING

Moody's will monitor the transaction on an ongoing basis to ensure that its transaction continues to perform in the manner expected, including checking all supporting ratings and reviewing the assets on an ongoing basis. Any subsequent changes in the rating will be publicly announced and disseminated through Moody's Client Service Desk.

RELATED RESEARCH

The following publications are available on www.moody.com:

Rating Methodology

- [Moody's Rating Approach to European Covered Bonds, 13 June 2005 \(SF57011\)](#)

Special Report

- [European Covered Bond Legal Frameworks: Moody's Legal Checklist, December 2005 \(SF66418\)](#)

Credit Opinion

- [Erste Bank der oest. Sparkassen AG, 14 July 2006](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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