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## Erste Group Bank AG

**Primary Credit Analyst:**

Anna Lozmann, Frankfurt (49) 69-33-999-166; [anna.lozmann@standardandpoors.com](mailto:anna.lozmann@standardandpoors.com)

**Secondary Contact:**

Pierre Gautier, Paris (33) 1-4420-6711; [pierre.gautier@standardandpoors.com](mailto:pierre.gautier@standardandpoors.com)

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# Erste Group Bank AG

## Major Rating Factors

### Strengths:

- Strong market position in Austria and several Central and Eastern European (CEE) countries.
- Stable operating revenues from traditional customer-led retail and commercial banking operations.
- Dominance of granular retail deposits in the funding structure, with only moderate reliance on wholesale funding.

### Counterparty Credit Rating

A/Watch Neg/A-1

### Weaknesses:

- Sensitivity to negative developments in the CEE region.
- High levels of nonperforming loans and loan loss provisions, stemming from exposures to riskier CEE countries.
- An only moderate capital position and limited capacity to strengthen capital internally.

## CreditWatch

Standard & Poor's Ratings Services' ratings on Austria-based Erste Group Bank AG (Erste) are on CreditWatch with negative implications. The CreditWatch mainly reflects our opinion that the introduction of special legislation to bail-in Hypo Group Alpe Adria's (HGAA's) subordinated debtholders, despite a grandfathered guarantee provided by the State of Carinthia, and the political considerations around the restructuring of HGAA may decrease the likelihood of extraordinary state support for Austria's systemically important banks. This could lead us to reduce or remove the notches of government support currently incorporated in the ratings and consequently lower, by up to two notches, the ratings on banks that we consider highly systemically important, including Erste.

We would likely downgrade Erste if the law is enacted as currently under discussion. We expect to resolve the CreditWatch over the next three months or once there is clarity on the timing and details of the upcoming law.

A downgrade could also be triggered by our reassessment of the economic or industry risks for banks operating in Austria, leading to a weaker starting point for our ratings on Austrian banks.

We could expect to resolve the CreditWatch if the government decided not to impose losses on grandfathered bond holders of HGAA. In this case, our assessment of the likelihood of state support for the bank will remain unchanged, and we would affirm the ratings and assign a negative outlook to reflect medium-term risks of diminishing extraordinary government support under the new EU Bank Recovery and Resolution Directive, as well as our view of banking industry risks in Austria and Erste's sensitivity to risk costs from its operations in Central and Eastern Europe.

## Rationale

The starting point for our ratings on Erste is its 'bbb+' anchor, which we base on our view of aggregate economic risks

in the countries where the bank operates and our industry risk assessment for Austria.

We assess Erste's stand-alone credit profile (SACP) at 'bbb+'. We consider Erste's business position "strong," as defined in our criteria, reflecting primarily its franchise in its home market of Austria and several CEE countries and also its focus on stable retail and corporate banking operations. We view capital and earnings as "moderate," and the main weakness to the ratings, based on our expectation that our risk-adjusted capital (RAC) ratio for Erste will remain in the 6.5%-7% range in the coming 24 months. Our assessment of Erste's risk position is "adequate," mainly reflecting good diversification of exposure. We view the bank's funding as "above average" and its liquidity as "adequate." These assessments are underpinned by Erste's large, granular, and stable deposit base and sound liquidity buffer.

The ratings also currently reflect Erste's high systemic importance in Austria and our assessment of Austria as supportive to its banking sector. These factors result in a two-notch uplift above the bank's SACP, leading to the issuer credit rating of 'A' on Erste.

### **Anchor: 'bbb+', reflecting economic risks in all countries of operations and industry risk in Austria**

Our bank criteria use our Banking Industry Country Risk Assessment to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our economic risk score for Austria is '2' on a scale of 1 to 10 (1 is the lowest risk and 10 the highest). However, the weighted average economic risk for countries in which Erste operates, based on the geographic distribution of its exposures at default, is close to '4'. We believe that Erste will retain its higher risk profile compared with purely domestic banks' because of its strong presence in CEE. We anticipate no material shift in the geographic split of the bank's exposures in the medium term.

Reflecting the average weighted economic risk score of '4' and industry risk score of '3' for the Austrian banking system, we derive the 'bbb+' anchor for Erste.

**Table 1**

<b>Erste Group Bank AG Key Figures</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(Mil. €)</b>	<b>2014*</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Adjusted assets	201,494.9	197,435.3	210,930.1	206,474.4	201,095.0
Customer loans (gross)	127,465.4	127,697.7	131,927.5	134,750.0	132,334.0
Adjusted common equity	12,096.9	11,973.6	11,346.7	9,967.9	9,922.0
Operating revenues	1,571.6	7,111.9	7,840.9	7,495.5	7,741.3
Noninterest expenses	963.5	4,188.6	4,809.7	4,254.5	4,142.3
Core earnings	139.8	646.1	830.5	570.2	1,167.2

\*Data as of March 31.

### **Business position: Strong and stable franchise in Austria and CEE**

We regard Erste's business position as "strong." This reflects the bank's strong and sustainable retail, small business, and corporate banking franchises in Austria, where Erste is among the top three banks that dominate the market. Equally important is Erste's strong position across several CEE countries, including Czech Republic, Slovakia, and Romania, where it is the market leader. We expect its market shares to remain stable overall, except in Hungary. Erste is not present in Russia, and it sold its subsidiary in Ukraine in 2013. We expect Erste to remain focused on only a few

markets in CEE with a comparably high market share.

Erste's "savings bank" brand is a plus in terms of image and customer loyalty, notably in Austria, but also in the Czech Republic and Slovakia. Its domestic retail operations are concentrated in 47 savings banks that differ widely in terms of size, performance, and credit quality.

Due to its widespread operations, Erste benefits from good geographic diversification of revenues, although we acknowledge certain correlations among CEE countries and between CEE and Austria. We also take into consideration Erste's exposure to some economically riskier countries in CEE. Both margins and credit losses are typically higher in CEE than in Austria, which means that the group's operations in these countries tend to heavily influence its profitability. Although Erste's Austrian operations show thin margins, they provide stable returns and we expect this trend to continue (1.9% net interest margin in Austria, in contrast to 3.9% from CEE for 2013).

In comparison with many large Western European banks, Erste has a stronger focus on retail clients, and it typically derives most of its revenues from that segment, along with small businesses and corporate lending, which we view as stable sources. We believe this will provide the business model with stability and compensate for Erste's lower business diversity than larger Western European banking groups'.

Erste's management team is stable and has followed a generally consistent strategy, in our view. The bank's overall goal is to build a large retail and corporate bank covering Austria and CEE, with top positions in each market but not covering all markets.

**Table 2**

Erste Group Bank AG Business Position					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Total revenues from business line (mil. €)	1,571.6	7,180.8	8,378.5	7,538.4	7,741.1
Commercial banking/total revenues from business line	22.6	6.6	5.8	6.4	9.1
Retail banking/total revenues from business line	52.4	76.5	68.8	79.7	79.6
Commercial & retail banking/total revenues from business line	75.0	83.1	74.6	86.2	88.8
Trading and sales income/total revenues from business line	7.0	6.4	6.1	6.5	7.3
Other revenues/total revenues from business line	18.0	10.5	19.3	7.3	4.0
Investment banking/total revenues from business line	7.0	6.4	6.1	6.5	7.3
Return on equity	3.6	0.5	3.2	(7.9)	7.8

\*Data as of March 31.

### Capital and earnings: Gradually improving, but still a weakness to the ratings

Erste's capital and earnings are, in our opinion, "moderate," and the weakness for the ratings. We base our assessment mainly on our projection that the RAC ratio for Erste will remain in the 6.5%-7% range over the next 24 months.

At year-end 2013, our RAC ratio for Erste was 6.5%, up from 6.3% as of year-end 2012. The improvement stemmed mainly from an increase in capital of €661 million, which however has only partly offset the bank's decreasing loss-absorption capacity following the repayment of participation capital. In 2013, Erste repaid participation capital provided by the Republic of Austria and other parties (€1.74 billion in total). The repayment did not affect our capital

ratio calculation because we did not include this instrument in our RAC ratio.

We expect the improved economic environment in the eurozone (European Economic and Monetary Union) to contribute to the development of Erste's domestic earnings and that Erste's capital base will continue to improve. However, we do not anticipate that the RAC ratio will increase materially higher than 7% over the next two years, owing to subdued overall performance as a result of still-high risk costs from the CEE operations. In our base-case assumptions we currently do not include any additional external capital measures. We expect Erste to stagnate in terms of lending volume and to report, at best, stable interest margins.

**Table 3**

<b>Erste Group Bank AG Capital And Earnings</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2014*</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Tier 1 capital ratio	10.4	11.8	11.6	10.4	10.2
S&P RAC ratio before diversification	N.M.	6.5	6.3	5.6	5.6
S&P RAC ratio after diversification	N.M.	7.4	7.3	6.4	6.2
Adjusted common equity/total adjusted capital	99.0	99.0	98.8	96.7	96.7
Net interest income/operating revenues	71.5	67.9	64.5	72.2	67.7
Fee income/operating revenues	28.8	25.5	21.9	23.8	25.0
Market-sensitive income/operating revenues	3.0	2.2	3.0	1.7	4.9
Noninterest expenses/operating revenues	61.3	58.9	61.3	56.8	53.5
Preprovision operating income/average assets	1.2	1.4	1.4	1.6	1.8
Core earnings/average managed assets	0.3	0.3	0.4	0.3	0.6

\*Data as of March 31. N.M.--Not meaningful.

**Table 4**

<b>Erste Group Bank AG RACF [Risk-Adjusted Capital Framework] Data</b>					
<b>(€)</b>	<b>Exposure*</b>	<b>Basel II RWA</b>	<b>Average Basel II RW (%)</b>	<b>Standard &amp; Poor's RWA</b>	<b>Average Standard &amp; Poor's RW (%)</b>
<b>Credit risk</b>					
Government and central banks	50,995,909,481	2,004,196,863	4	11,906,867,378	23
Institutions	22,960,064,637	2,854,380,300	12	4,342,639,299	19
Corporate	72,601,045,694	50,382,637,138	69	77,970,302,026	107
Retail	67,362,568,222	21,187,205,950	31	37,350,248,166	55
Of which mortgage	39,693,181,941	9,752,589,000	25	13,473,315,369	34
Securitization	1,266,218,117	892,745,438	71	1,467,724,482	116
Other assets	13,454,801,493	4,600,100,400	34	16,079,083,382	120
Total credit risk	228,640,607,644	81,921,266,088	36	149,116,864,733	65
<b>Market risk</b>					
Equity in the banking book <sup>¶</sup>	2,835,318,000	2,008,668,138	74	12,247,537,070	432
Trading book market risk	--	2,852,375,000	--	4,278,562,500	--
Total market risk	--	4,861,043,138	--	16,526,099,570	--

Table 4

## Erste Group Bank AG RACF [Risk-Adjusted Capital Framework] Data (cont.)

<b>Insurance risk</b>					
Total insurance risk	--	--	--	2,094,725,000	--
<b>Operational risk</b>					
Total operational risk	--	10,187,500,000	--	17,147,017,606	--
		<b>Basel II RWA</b>		<b>Standard &amp; Poor's RWA</b>	<b>% of Standard &amp; Poor's RWA</b>
<b>Diversification adjustments</b>					
RWA before diversification		96,969,809,225		184,884,706,910	100
Total adjustments to RWA		--		(22,210,720,867)	(12)
RWA after diversification		96,969,809,225		162,673,986,042	88
		<b>Tier 1 capital</b>	<b>Tier 1 ratio (%)</b>	<b>Total adjusted capital</b>	<b>Standard &amp; Poor's RAC ratio (%)</b>
<b>Capital ratio</b>					
Capital ratio before adjustments		11,560,000,000	11.9	12,097,631,000	6.5
Capital ratio after adjustments§		11,560,000,000	11.8	12,097,631,000	7.4

\*Exposure at default. Securitisation exposure includes the securitisation tranches deducted from capital in the regulatory framework. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2013, and Standard & Poor's.

### Risk position: Our RAC ratio appropriately captures Erste's riskier exposures

We assess Erste's risk position as "adequate." Risk exposure is widely diversified between countries and retail and corporate clients. Single-name and sector concentrations in the loan book are low. Our capital framework captures Erste's risks of operating in more vulnerable countries than Austria or higher-risk sectors, such as construction and real estate development, by applying higher risk weights in calculating our RAC ratio.

We believe that Erste's risk management is comprehensive and efficient, which is crucial in light of the bank's geographic reach. There are no particularly complex businesses or products, and the bank's governance does not present unusual risk. All the CEE operations are operationally run as stand-alone banks applying the bank's strategy locally and using its risk tools and framework.

The same rules also apply for the savings banks network in Austria. Although Erste owns the majority of only four of the 47 savings banks, it exercises control over the members of the cross-guarantee system through its majority ownership of the system's management company. The management company has the power to implement and monitor risk policies, as well as intervene if a savings bank breached the network's policies.

We regard risks not fully covered by our capital framework, such as credit spread or interest rate risk in the banking book, as limited.

There is potential credit risk for the bank from lending in foreign currency. Currency risk for customers, which could translate into credit risk for the bank, is a legacy issue particularly in Austria and at certain subsidiaries.

Erste's nonperforming loans and cost of risk have been higher than that of peers with similar economic risk. Nonperforming loans represented 9.6% of customer loans at the end of March 2014. In our base-case scenario, we anticipate a stabilization of Erste's asset quality metrics. Any further material increase in nonperforming loans or cost of risk would not be consistent with our current assessment of the bank's risk position as "adequate."

**Table 5**

Erste Group Bank AG Risk Position					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Growth in customer loans	(0.7)	(3.2)	(2.1)	1.8	2.5
Total diversification adjustment / S&P RWA before diversification	N.M.	(12.0)	(14.0)	(12.5)	(9.3)
Total managed assets/adjusted common equity (x)	16.9	16.7	18.8	21.1	20.7
New loan loss provisions/average customer loans	1.1	1.4	1.5	1.7	1.6
Gross nonperforming assets/customer loans + other real estate owned	9.6	9.6	9.2	8.5	7.6
Loan loss reserves/gross nonperforming assets	62.6	63.5	63.2	61.7	60.9

\*Data as of March 31. N.M.--Not meaningful.

### Funding and liquidity: Stable and granular customer deposits

We consider Erste's funding to be "above average" and its liquidity to be "adequate." This reflects our view of the stability of Erste's retail funding base, especially in its largest markets in Austria, Czech Republic, and Slovakia, as well as its only moderate reliance on wholesale funding, which drives the "above average" funding score.

Erste's large retail branch network in Austria and CEE, and its relationships with domestic corporate clients, provide it with a stable and granular deposit base, with very low single-name concentrations. Erste's customer deposits have been increasing in Austria and CEE, and did so even during the latest crisis, underlining the group's funding strength. In the event of market stress, we expect Erste's retail operations, particularly in Austria and at its core subsidiaries in Czech Republic and Slovakia, to benefit from potential "flight to quality."

The ratio of loans to deposits was about 100% at the end of March 2014 and compares very well with peers', even though it masks discrepancies between very liquid subsidiaries (in Czech Republic and Slovakia) and those that depend on parental funding (for example, in Hungary and Croatia). We expect the loan-to-deposit ratio to gradually improve to a more adequate level throughout the group in the medium term, also reflecting more stringent regulatory requirements.

At the end of March 2014, wholesale funding (which we define as interbank, unsecured, and secured issues) accounted for a moderate one-third of Erste's total funding. Short-term funds accounted for about two-thirds of total wholesale funding (including interbank loans). Standard & Poor's stable funding ratio for Erste fluctuates around 120%, reinforcing our assessment of "above average" funding.

Our assessment of Erste's liquidity as "adequate" primarily reflects the bank's prudent liquidity management and high liquidity reserves. Standard & Poor's liquidity ratio, which shows coverage of short-term wholesale funding by broad

liquid assets, was high for Erste at almost 3x as of year-end 2013. However, we cannot assume full tangibility of liquidity within the bank's foreign branches and the Austrian savings banks, which prevents a better liquidity assessment for the group. Erste's solid consolidated liquidity ratios do not reflect discrepancies at individual foreign subsidiaries, which continue to report disparate liquidity levels.

**Table 6**

<b>Erste Group Bank AG Funding And Liquidity</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2014*</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Core deposits/funding base	67.7	70.9	67.7	65.6	66.5
Customer loans (net)/customer deposits	100.8	97.9	101.0	107.4	107.9
Long term funding ratio	88.1	90.1	89.5	88.1	87.9
Stable funding ratio	119.9	121.0	119.2	113.0	108.7
Short-term wholesale funding/funding base	12.8	10.6	11.2	12.5	12.8
Broad liquid assets/short-term wholesale funding (x)	2.5	2.9	2.6	2.1	1.9
Net broad liquid assets/short-term customer deposits	50.1	49.9	41.2	25.8	21.1
Short-term wholesale funding/total wholesale funding	39.5	36.3	34.6	36.2	38.0

\*Data as of March 31.

### **External support: Two notches of uplift for government support**

The long-term rating on Erste is two notches higher than the 'bbb+' SACP, owing to our view of a "moderately high" likelihood of support for Erste from the Austrian government. This assessment is based on our view of Erste's high systemic importance in Austria and the Austrian government as supportive to the banking sector. For these assessments, we assume that Erste will retain its important role in financing the local economy and its high share of customer deposits. As of year-end 2013, Erste held about 18% of the system's customer deposits.

The Austrian government's decision to introduce special legislation to bail-in HGAA's subordinated debtholders, despite a grandfathered guarantee provided by the State of Carinthia, and the developments surrounding HGAA, can trigger a general change in the Austrian government's attitude toward support for banks. This could lead us to reduce or remove the notches of government support currently incorporated in the ratings on Austrian banks and consequently lower by up to two notches the ratings on banks that we consider highly systemically important, including Erste.

At the latest, within two years, the potential extraordinary government support available to Erste's senior unsecured bondholders will likely diminish. We could reduce or remove the notches for extraordinary state support in our rating on Erste shortly before the January 2016 introduction of the EU Bank Recovery and Resolution Directive bail-in powers for senior unsecured liabilities. These rules would indicate to us that EU governments would be much less able to support senior unsecured bank creditors, even though it may take several more years to eliminate concerns about financial stability and the resolvability of systemically important banks.

### **Additional rating factors: None**

No additional factors affect the rating.



## Related Criteria And Research

### Related Criteria

- Group Rating Methodology, Nov. 19, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

### Related Research

- Erste Group Bank 'A/A-1' Ratings Placed On CreditWatch Negative On Risks Of Diminishing State Support, June 10, 2014
- Seven Austrian Banks Placed On CreditWatch Negative On Planned Bail-In Of State-Guaranteed Debt Of Hypo Group Alpe Adria, June 10, 2014
- Banking Industry Country Risk Assessment: Austria, June 3, 2014
- Banking Industry Country Risk Assessment Update: May 2014, May 13, 2014
- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
- Credit FAQ: The Rating Impact Of Resolution Regimes For European Banks, April 29, 2014

### Ratings Detail (As Of June 23, 2014)

#### Erste Group Bank AG

Counterparty Credit Rating	A/Watch Neg/A-1
Commercial Paper	A-1/Watch Neg
Senior Unsecured	A/Watch Neg
Subordinated	BBB/Watch Neg

#### Counterparty Credit Ratings History

10-Jun-2014	A/Watch Neg/A-1
25-Jan-2012	A/Negative/A-1
08-Dec-2011	A/Watch Neg/A-1
11-Oct-2011	A/Negative/A-1
24-Nov-2010	A/Stable/A-1

#### Sovereign Rating

Austria (Republic of)	AA+/Stable/A-1+
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#### Related Entities

##### Ceska Sporitelna A.S.

Issuer Credit Rating	A/Watch Neg/A-1
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##### Slovenska Sporitelna A.S. (Unsolicited Ratings)

Issuer Credit Rating	
Local Currency	Api/--/--

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

#### Additional Contact:

Financial Institutions Ratings Europe; FIG\_Europe@standardandpoors.com

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