

# RatingsDirect®

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## Erste Group Bank AG

**Primary Credit Analyst:**

Salla von Steinaecker, Frankfurt (49) 69-33-999-164; [salla.vonsteinaecker@standardandpoors.com](mailto:salla.vonsteinaecker@standardandpoors.com)

**Secondary Contact:**

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

### Table Of Contents

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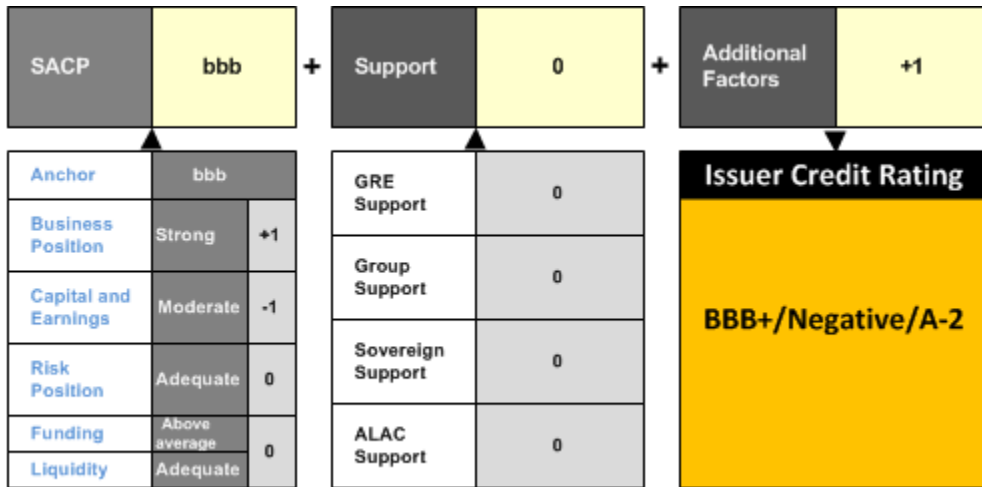
Major Rating Factors

Outlook

Rationale

Related Criteria And Research

# Erste Group Bank AG



ALAC--Additional loss-absorbing capacity. SACP--Stand-alone credit profile GRE--Government-related entity

## 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.

### Weaknesses:

- Sensitivity to developments in the CEE region.
- Still high levels of nonperforming loans, stemming from exposures to riskier CEE countries.
- Comparably moderate capital levels.

### Counterparty Credit Rating

BBB+/Negative/A-2

## Outlook

Standard & Poor's Ratings Services' negative outlook on Erste Group Bank AG (Erste) reflects the risk that Erste's internal capital generation could prove to be slower than we anticipate, with its risk-adjusted capital (RAC) ratio remaining below 7% over the next two years.

It also reflects the risk that the bank does not accumulate a hybrid capital buffer to provide sufficient protection for senior unsecured creditors, as reflected in an additional loss-absorbing capacity (ALAC) proportion of risk-weighted assets, as calculated by Standard & Poor's, above 5%.

We may lower the rating if unexpected material risks arise from the bank's CEE operations, causing its asset quality to

deteriorate.

We could revise the outlook on Erste to stable over the next two years if we concluded that its capitalization or its hybrid issuance buffer are improving simultaneously, potentially leading to a RAC ratio above 7% and ALAC above 5%. However, materialization of these developments simultaneously would likely require material external capital inflow.

## Rationale

The starting point for our ratings on Erste is its 'bbb' anchor, which we base on our view of weighted 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 as "strong," as defined by our criteria, capital and earnings as "moderate," risk position as "adequate," funding as "above average," and its liquidity as adequate.

We make a one-notch upward adjustment to the long-term issuer rating, as we anticipate positive momentum in the bank's earnings after the clean-up of its portfolio in 2014 and management's plans to issue hybrid capital to strengthen Erste's profile over the medium term.

We believe that the prospect of extraordinary government support for the Austrian banking sector is uncertain and do not incorporate any uplift above the bank's SACP for government support.

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

Table 1

Erste Group Bank AG Key Figures					
	--Year-ended Dec. 31--				
(Mil. €)	2015*	2014	2013	2012	2011
Adjusted assets	201,155.1	194,846.4	197,435.3	210,930.1	206,474.4
Customer loans (gross)	130,611.2	128,325.0	127,697.7	131,927.5	134,750.0
Adjusted common equity	11,571.0	11,178.0	11,973.6	11,346.7	9,967.9
Operating revenues	1,642.0	5,900.6	7,111.9	7,840.9	7,495.5
Noninterest expenses	948.1	3,787.3	4,188.6	4,809.7	4,254.5
Core earnings	296.6	(837.6)	646.1	830.5	570.2

\*Data as of March 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

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 of economic risks of countries in which Erste operates, based on the geographic distribution of its exposures at default, is close to '4' (rounded largest shares as of end-2014: Austria 60%, the Czech Republic 15%, Romania 10%, and Slovakia 5%). 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 '4' for the Austrian banking system, we derive a 'bbb' anchor for Erste.

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

Table 2

Erste Group Bank AG Business Position					
	--Year-ended Dec. 31--				
(%)	2015*	2014	2013	2012	2011
Loan market share in country of domicile	N/A	19.0	19.0	19.0	19.0
Deposit market share in country of domicile	N/A	19.0	19.0	20.0	20.0
Total revenues from business line (currency in millions)	1,642.0	5,900.6	7,180.8	8,378.5	7,538.4
Commercial banking/total revenues from business line	21.4	24.7	6.6	5.8	6.4
Retail banking/total revenues from business line	50.2	56.2	76.5	68.8	79.7
Commercial & retail banking/total revenues from business line	71.6	81.0	83.1	74.6	86.2
Trading and sales income/total revenues from business line	6.9	7.0	6.4	6.1	6.5
Other revenues/total revenues from business line	21.5	12.0	10.5	19.3	7.3
Investment banking/total revenues from business line	6.9	7.0	6.4	6.1	6.5
Return on equity	9.0	(13.6)	0.5	3.2	(7.9)

\*Data as of March 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

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 (19% share of retail loans and deposits). Equally important is Erste's strong position across several CEE countries, including Czech Republic, Slovakia, and Romania, where it is the market leader (by retail loans and deposits, respectively: 23% and 26% in the Czech Republic, 27% and 26% in Slovakia, 18% and 17% in Romania). We expect its market shares to remain stable overall, except in Hungary. Positively, Erste is not present in Russia and Ukraine, which we consider higher risk countries. 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. Domestic retail operations are concentrated in 47 savings banks that differ widely in terms of size.

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 these countries tend to heavily influence the group's profitability. Although Erste's Austrian operations show thin margins, they provide stable returns and we expect this trend to continue (1.6% net interest margin in Austria, in contrast to 3.6% from CEE for 2014).

In comparison with many large Western European banks, Erste has a stronger focus on retail clients (56% of total

revenues in 2014), and typically derives most of its revenues from that segment, along with small businesses and corporate lending (25% of total revenues), 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. The bank's overall goal is to build a large retail and corporate bank covering Austria and CEE (the Eastern part of the European Union) with top positions in each market but not covering all markets.

### Capital and earnings: Capitalization remains the main weakness to the rating

**Table 3**

Erste Group Bank AG Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2015*	2014	2013	2012	2011
Tier 1 capital ratio	10.2	10.6	11.8	11.6	10.4
S&P RAC ratio before diversification	N.M.	6.0	6.6	6.3	5.6
S&P RAC ratio after diversification	N.M.	6.6	7.5	7.3	6.4
Adjusted common equity/total adjusted capital	99.0	98.9	99.0	98.8	96.7
Net interest income/operating revenues	66.9	76.2	67.9	64.5	72.2
Fee income/operating revenues	28.1	31.7	25.5	21.9	23.8
Market-sensitive income/operating revenues	5.3	(5.4)	2.2	3.0	1.7
Noninterest expenses/operating revenues	57.7	64.2	58.9	61.3	56.8
Preprovision operating income/average assets	1.4	1.1	1.4	1.4	1.6
Core earnings/average managed assets	0.6	(0.4)	0.3	0.4	0.3

\*Data as of March 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful. RAC--Risk-adjusted capital

**Table 4**

Erste Group Bank AG RACF [Risk-Adjusted Capital Framework] Data					
	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
<b>Credit risk</b>					
Government and central banks	52,529,082,324	2,107,581,413	4	11,110,292,416	21
Institutions	19,008,180,418	4,182,706,013	22	4,881,796,407	26
Corporate	71,970,270,844	49,474,054,650	69	77,179,740,795	107
Retail	68,816,163,640	21,381,005,000	31	40,021,699,970	58
Of which mortgage	32,269,789,159	8,151,891,863	25	11,481,745,126	36
Securitization§	1,030,946,585	583,038,800	57	2,031,715,945	197
Other assets	10,258,920,374	5,109,425,463	50	13,050,926,545	127
Total credit risk	223,613,564,185	82,837,811,338	37	148,276,172,079	66
<b>Market risk</b>					
Equity in the banking book†	2,182,268,628	2,749,004,663	134	18,207,473,587	834
Trading book market risk	--	3,263,012,500	--	4,894,537,500	--

Table 4

Erste Group Bank AG RACF [Risk-Adjusted Capital Framework] Data (cont.)					
Total market risk	--	6,012,017,163	--	23,102,011,087	--
<b>Operational risk</b>					
Total operational risk	--	10,275,000,000	--	17,383,790,054	--
		<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		100,674,828,500		188,761,973,220	100
Total Diversification/Concentration Adjustments		--		(17009180882)	(9)
RWA after diversification		100,674,828,500		171,752,792,338	91
		<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		10,811,000,000	10.7	11,298,223,000	6
Capital ratio after adjustments†		10,811,000,000	10.7	11,298,223,000	6.6

\*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, 2014, Standard & Poor's.

Erste's capital and earnings are, in our opinion, "moderate." We base our assessment mainly on our projection that the RAC ratio for Erste will continue to increase from 6% as of end-2014 but will remain below 7% in the next two years. This is unless it is supported by hybrid issues which qualify as capital under Standard & Poor's definition or stronger-than-expected earnings generation. We expect that the RAC increase will be supported by slowly improving economic environments in Erste's countries of operation.

In our base case assumptions we 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. Following the clean-up in 2014, we expect that the bottom line will--at least in the short term--benefit from risk costs, which are materially lower than in the recent years.

We consider that Erste's retail and small and midsize enterprise (SME) focus supports its quality of earnings, making revenues predictable and relatively resilient to economic swings. The volatile portion of revenues are, on average, small. Nonrecurring elements have traditionally been low for Erste.

Almost one-third of the total adjusted capital (TAC)—Standard & Poor's main measure of the capital buffer—is constituted by minority capital. However, in our opinion, this does not weaken the quality of the capital base because of the way that the cross-guarantee system in the Austrian savings bank sector is set up. The steering company, in which Erste indirectly holds 51%, implements the provisions of the agreement governing the cross-guarantee system. As Erste owns the controlling interest in the steering company, it has to fully consolidate all members of the cross-guarantee system according to International Financial Reporting Standards (IFRS) rules. At the same time, Erste indirectly controls the uniform risk management and strategy across the sector (see also Risk position). Hybrids

included in TAC were negligible at 1% as of 2014-end, which contributed to the overall quality of capital.

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

Table 5

Erste Group Bank AG Risk Position					
	--Year-ended Dec. 31--				
(%)	2015*	2014	2013	2012	2011
Growth in customer loans	7.1	0.5	(3.2)	(2.1)	1.8
Total diversification adjustment / S&P RWA before diversification	N.M.	(9.0)	(11.7)	(14.0)	(12.5)
Total managed assets/adjusted common equity (x)	17.5	17.6	16.7	18.8	21.1
New loan loss provisions/average customer loans	0.6	1.7	1.4	1.5	1.7
Gross nonperforming assets/customer loans + other real estate owned	8.4	8.9	9.6	9.2	8.5
Loan loss reserves/gross nonperforming assets	65.5	65.9	63.5	63.2	61.7

\*Data as of March 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful. RWA--Risk-weighted assets

We assess Erste's risk position as adequate. Risk exposures are widely diversified between countries and retail and corporate clients. Single-name and sector concentrations in the loan book are, in our view low. Furthermore, 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 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 currencies, particularly in Swiss francs, which constituted 6.2% of the loan portfolio as of March-end 2015. 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 are on a declining trend, but represented a still-high 8% of customer loans at the end of March 2015. In our base-case scenario, we anticipate a stabilization of Erste's asset quality metrics over the next two years.

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

**Table 6**

<b>Erste Group Bank AG Funding And Liquidity</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2015*</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Core deposits/funding base	71.9	72.2	70.7	67.7	65.6
Customer loans (net)/customer deposits	99.5	99.0	97.9	101.0	107.4
Long term funding ratio	91.3	90.8	89.9	89.5	88.1
Stable funding ratio	122.2	121.5	121.0	119.2	113.0
Short-term wholesale funding/funding base	9.3	9.8	10.8	11.2	12.5
Broad liquid assets/short-term wholesale funding (x)	3.3	3.0	2.8	2.6	2.1
Net broad liquid assets/short-term customer deposits	48.3	44.9	49.3	41.2	25.8
Short-term wholesale funding/total wholesale funding	33.0	35.3	36.8	34.6	36.2

\*Data as of March 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

We consider Erste's funding to be above average and its liquidity 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. 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 99% at the end of March 2015 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 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 2015, wholesale funding (which we define as interbank, unsecured, and secured issues) accounted for less than one-third of Erste's total funding. Short-term funds accounted for one-third of total wholesale funding (including interbank loans). Standard & Poor's stable funding ratio for Erste fluctuates around 120%, reinforcing our above average assessment.

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 at 3x at the end of March 2015. 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.

### **External support: No uplift for government support or ALAC**

We believe the prospect of extraordinary government support for Austrian banks is now uncertain, following the full implementation of the EU Bank Recovery and Resolution Directive, including bail-in powers, in January 2015. We



therefore classify Austria's tendency to support private sector commercial banks as "uncertain" under our criteria.

Our assessment of Erste's ALAC does not currently lead us to add any uplift to the ratings. We nevertheless view the Austrian resolution regime as "effective" under our ALAC criteria because, among other factors, we believe it contains a well-defined bail-in process under which authorities would permit non-viable systemically important banks to continue critical functions as going concerns following a bail-in of eligible liabilities.

We include all of the consolidated Erste group's junior instruments in our ALAC assessment because, over our projection period, we believe they have capacity to absorb losses without triggering a default on Erste's senior obligations. On this basis, we calculate that the ALAC proportion of risk-weighted assets was slightly below the 5% threshold at year-end 2014.

### **Additional rating factors: Positive additional notch for further capital build-up**

We adjust the ratings on Erste upward by one notch, as we anticipate positive momentum in the bank's earnings after the clean-up of its portfolio in 2014 and management's plans to issue hybrid capital to strengthen Erste's profile over the medium term.

We believe Erste's ALAC ratio may increase above 5% if the management issues additional eligible hybrids, as planned. However, we currently have no final certainty regarding the volume of hybrid issuance and the future regulatory requirements on Erste to increase the buffer of instruments that we expect will be ALAC-eligible. We anticipate that this regulatory transition period, and so the ramp-up of the ALAC buffer, could take up to four years, because we believe Austria is in an extended regulatory transition period in which banks will progressively build larger buffers of loss-absorbing capacity.

We also consider that Erste's internal capital accumulation could improve following the clean-up of its portfolio in 2014, therefore helping improve its capital buffer over the next two years. If Erste's planned hybrid issues qualify for inclusion in our capital calculation, resulting in our RAC ratio increasing above 7%, this could improve our view of the bank's capital and earnings position.

## **Related Criteria And Research**

### **Related criteria**

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

### **Related research**

- Ratings On Some Austrian Banks Lowered On Less Predictable State Support And Increasing Industry Risks, June 9, 2015
- S&P Takes Various Rating Actions On Certain U.K. And German Banks Following Government Support And ALAC Review, June 9, 2015

- Watch Placements For Systemic Austrian, German, And U.K. Bank Operating Companies To Be Reviewed Around End May 2015, April 16, 2015
- S&P Takes Various Rating Actions On Certain U.K., German, Austrian, And Swiss Banks Following Government Support Review, Feb. 3, 2015
- The Rating Implications Of The Emerging Bank Resolution Frameworks In The U.K., Germany, Austria, And Switzerland, Feb. 3, 2015
- Austria, Germany, And The U.K. Are Set To Fast Track EU Bank Bail-In Rules, Sept. 29, 2014
- How The Regulatory Reform Process Could Reshape Banks' Business Models And Affect Issuer Ratings, Aug. 18, 2014
- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
- The Rating Impact Of Resolution Regimes For European Banks, April 29, 2014

### Ratings Detail (As Of June 25, 2015)

#### Erste Group Bank AG

Counterparty Credit Rating	BBB+/Negative/A-2
Commercial Paper	A-2
Senior Unsecured	BBB+
Subordinated	BB+

#### Counterparty Credit Ratings History

09-Jun-2015	BBB+/Negative/A-2
03-Feb-2015	A-/Watch Neg/A-2
13-Aug-2014	A-/Negative/A-2
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-/Negative/A-2
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\*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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

#### Additional Contact:

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

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