

# MOODY'S

## INVESTORS SERVICE

### Credit Opinion: Jyske Bank A/S

Global Credit Research - 29 Apr 2013

Silkeborg, Denmark

#### Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Baa1/P-2
Bank Financial Strength	C-
Baseline Credit Assessment	(baa2)
Adjusted Baseline Credit Assessment	(baa2)
Senior Unsecured	Baa1
Jr Subordinate	Ba1 (hyb)
Pref. Stock	Ba2 (hyb)
Other Short Term	(P)P-2

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#### Key Indicators

##### JYSKE BANK A/S (Consolidated Financials)[1]

	[2]12-12	[2]12-11	[2]12-10	[2]12-09	[2]12-08	Avg.
Total Assets (DKK million)	258,240.0	270,210.0	244,108.2	224,593.8	236,301.7	[3]2.2
Total Assets (EUR million)	34,612.4	36,356.0	32,757.1	30,183.6	31,747.3	[3]2.2
Total Assets (USD million)	45,632.7	47,195.4	43,945.1	43,305.6	44,130.2	[3]0.8
Tangible Common Equity (DKK million)	16,233.5	14,430.5	14,012.2	12,352.3	10,116.2	[3]12.6
Tangible Common Equity (EUR million)	2,175.8	1,941.6	1,880.3	1,660.0	1,359.1	[3]12.5
Tangible Common Equity (USD million)	2,868.6	2,520.5	2,522.5	2,381.7	1,889.2	[3]11.0
Net Interest Margin (%)	1.9	2.0	2.0	2.0	1.6	[4]1.9
PPI / Average RWA (%)	2.5	2.1	2.7	3.2	1.5	[5]2.4
Net Income / Average RWA (%)	0.6	0.5	0.8	0.5	0.5	[5]0.6
(Market Funds - Liquid Assets) / Total Assets (%)	1.7	3.0	3.7	7.4	9.0	[4]5.0
Core Deposits / Average Gross Loans (%)	91.1	98.6	85.0	79.6	77.7	[4]86.4
Tier 1 Ratio (%)	15.3	13.3	13.6	13.5	9.9	[5]13.1
Tangible Common Equity / RWA (%)	15.1	13.2	13.3	12.3	8.6	[5]12.5
Cost / Income Ratio (%)	64.0	67.7	59.2	52.5	67.6	[4]62.2
Problem Loans / Gross Loans (%)	5.4	5.4	6.4	5.8	2.0	[4]5.0
Problem Loans / (Equity + Loan Loss Reserves) (%)	31.7	37.5	41.5	41.6	22.1	[4]34.9

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel II & IFRS reporting periods have been used for average calculation

#### Opinion

## **SUMMARY RATING RATIONALE**

Moody's rates Jyske Bank Baa1/Prime-2/C-. The C- standalone bank financial strength rating (BFSR) assigned to Jyske Bank, which maps to a standalone baseline credit assessment (BCA) of baa2, reflects the bank's good domestic franchise. However, the rating is constrained by the challenging domestic operating environment which results in the bank's limited net profit and volatile earnings (due to mark-to-market adjustments), as well as the ongoing need to focus on managing asset quality, particularly lending to commercial real estate and agriculture, through the economic downturn. We also caution that low interest rate levels have thus far supported borrowers' ability to repay their debts but loans with variable rates are vulnerable to interest rate hikes.

Moody's considers Denmark as a low support country, primarily reflecting the government's willingness to impose losses on senior creditors and depositors in accordance with the bail-in legislation implemented in October 2010 (Bank Package III) and as evidenced by the bail-in of Amagerbanken and Fjordbank Mors in 2011. In view of Jyske Bank's position in Denmark and strength in Jutland and despite its only moderate nationwide coverage, Moody's takes into account a one-notch systemic support uplift for Jyske Bank's Baa1 long-term GLC deposit rating from its baa2 standalone financial strength. As expected Jyske Bank was identified as a SIFI in the report from the committee on systemically important financial institutions in Denmark, released on 14 March 2013.

Unless otherwise stated, the figures included in this report are taken from Moody's Bank Financial Metrics, based on company reports with standard adjustments where relevant, or from company reports directly.

### **Rating Drivers**

- Good domestic franchise
- Core profitability weakened due to operating environment
- Improved Funding Profile
- Asset quality deterioration, and some credit concentration in the lending portfolio

### **Rating Outlook**

The outlook on all ratings is stable.

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

Rating upgrades are unlikely in the near future, given the stable outlook. A limited amount of upward rating momentum could develop if Jyske Bank demonstrates (i) continued good access to capital markets, (ii) stronger and more stable earnings generation without an increase in its risk profile and/or (iii) improved asset quality management especially in relation to more volatile segments such as agriculture and commercial real estate.

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

While the current rating levels incorporate a degree of expected further deterioration, ratings may decline further if (i) Jyske Bank's financing conditions become more difficult, (ii) its asset quality deteriorates more than we anticipate and/or (iii) its risk profile increases, for example as a result of increased exposures to more volatile sectors or increased involvement in more risky operations such as capital market activities.

### **Recent Results**

Jyske Bank's 2012 results highlighted another year with a challenging macroeconomic environment in Denmark with lending falling 2.4% and loan loss provisions remaining elevated at 1.5% of gross loans. The falling Danish interest rates during 2012 put additional pressure on the bank's interest margin, but had a positive impact on the return on the bank's investment portfolio and on commissions related to refinancing of mortgage loans.

Due mainly to higher loan loss provisions, Jyske Bank's core earnings before tax (including contributions to the Danish guarantee fund of DKK109 million and a goodwill write down of DKK216 million ) fell to DKK239 million from DKK255 million in 2011 (including DKK172 million contribution to the Danish guarantee fund) despite a DKK342 million increase in commission income. Earnings from the investment portfolios increased to DKK612 million from DKK346 million.

The continued high level of loan losses in the Danish banking sector, despite the record low interest rates in 2012, highlight the difficulty still faced by many borrowers, and with economic growth in Denmark expected to remain very modest also in the coming years, credit quality is likely to remain an issue for the banking sector. We note that the level of loan losses in 2012 was impacted by the new stricter guidelines imposed by the Danish FSA on all Danish banks in 2012.

In the current environment Jyske Bank sees an opportunity to grow via acquisitions. Following two smaller acquisitions in 2011, Jyske Bank announced the acquisition of Danish local bank, Sparekassen Lolland, in January 2013. Net loans taken over from Sparekassen Lolland amount to around 6% of total lending in the consolidated group. Jyske Bank assumed all assets and liabilities of Sparekassen Lolland, except subordinated capital, and took over all customers, employees and branches. The takeover by Jyske Bank was a result of a protracted period of economic difficulties at Sparekassen Lolland, largely resulting from the group's large exposure to commercial real estate which stood at 25.2% of total lending at end-September 2012.

## **DETAILED RATING CONSIDERATIONS**

### **GOOD DOMESTIC FRANCHISE**

Jyske Bank enjoys a solid franchise as one of the leading banks in Denmark, with total assets of DKK258.2 billion (EUR34.7 billion) at YE2012. Jyske Bank is the third largest bank for both deposits and lending with market shares, based on Moody's estimates, of approximately 8% and 9%, respectively. The bank has a nationwide presence, with its strongest franchise in Jutland, where the majority of its branches and its headquarters are located.

Jyske Bank has cooperation agreements with mortgage, life insurance and asset management providers, which enable it to maintain cost efficiency while maintaining product depth.

A large proportion of mortgage loans originated by the bank are financed by Totalkredit and DLR Kredit and as such do not appear on the bank's balance sheet.

In the current low growth environment, Jyske Bank has focused on acquisitions to grow the operations. In September 2011, Jyske Bank acquired part of the leasing arm of Spar Nord, Easy Fleet and Finans Nord. Moody's expect that this will further strengthen Jyske Bank's growth strategy and increase lending potential for the group.

Additionally, in October 2011, the bank took over deposits of DKK3.5 billion and total lending of DKK2.3 billion through the acquisition of parts of Fjorbank Mors from the Financial Stability Company. Moody's positively notes that this has given Jyske Bank a key presence in the Mors region in Jutland.

On 25 January 2013 Jyske Bank announced the takeover of Sparekassen Lolland, adding DKK7.1 billion loans, DKK9.7 billion deposits and 13 branches to Jyske Bank's franchise. The branches are mainly located on the island of Lolland in Southern Denmark. Sparekassen Lolland also included the web bank, Finansnetbanken, with around 70,000 customers.

Moody's expect consolidation of the Danish banking sector to continue throughout 2013 which will give more opportunities to gain market share in a market where organic growth is limited.

### **CORE PROFITABILITY WEAKENED DUE TO OPERATING ENVIRONMENT**

Jyske Bank's core earnings (earnings excluding investment portfolio income) remain adequate on a pre-provision level, reflecting the group's strong franchise. However, the continued elevated level of provisioning due to the challenging operating environment means that core earnings after provisions remain relatively low, generating low single digit returns on Jyske Bank's core capital base. More than half of the group's pre-tax result has been generated by income on the investment portfolio in recent years, increasing the volatility and reducing the quality of the group's earnings base. For the full year 2012, Jyske Bank reported a pre-tax profit of DKK851 million, up 42% from DKK601 million at YE2011.

Jyske Bank's risk weighted pre-provision profitability of 2.51% in 2012 indicates an adequate profitability relative to the peers and was higher than in 2011 (2.05%) and the 2.43% three year average. Net interest income from customer operations (core interest income) and the net interest margin remained largely stable in 2012 relative to 2011 and the last three year average, as interest hikes implemented during 2011 and 2012 compensated for the negative effect of falling loan balances and the low interest rate level that is putting pressure on deposit margins. Net fee and commission income increased to DKK1.65 billion from DKK1.3 billion largely as a result of higher asset management fees and fees relating to customers converting mortgage loans.

Due to the higher total income, including higher value adjustments, and flat costs excluding goodwill writedowns, the cost/ income ratio fell to 64% from 68% in 2011. The number of full time employees fell to 3,574 from 3,809 in 2011. Out of the 235 reduction in FTEs, 180 resulted from employees being transferred to the new IT provider Bankdata. Jyske Bank's cost/ income ratio is however still around 10 percentage points higher than its peer average.

Loan loss provisions increased to approximately DKK1.8 billion in 2012, from DKK1.5 billion in 2011, and accumulated loan loss provisions amounted to DKK4.7 billion, up from DKK3.9 billion in 2011. Of total provisions, 82% was related to corporate customers, primarily from real estate, agriculture, and construction. Writedowns relative to total exposures in these three sectors were 5.8%, 5.7% and 2.8% respectively at end-2012. In comparison, 1.2% of the retail exposure had been written down at end 2012, however the level of problem loans to retail customers increased 17% in 2012. We note that the level of loan losses in 2012 was impacted by the new stricter guidelines imposed by the Danish FSA on all Danish banks in 2012.

It will be important for Jyske Bank to improve its core top-line results going forward in order to improve return on capital. Loan losses look likely to remain elevated in the coming years as Moody's expects customers to face continued challenges due to, amongst others, the effects of a prolonged slow growth environment. At the same time asset prices in real estate and agriculture seem unlikely to show significant recovery in the coming years. We also expect possibilities for Jyske to implement further cost cutting to mitigate top-line pressure may be challenging, although further cost synergies are expected from the IT conversion to BankData.

#### IMPROVED FUNDING PROFILE

Jyske Bank has improved its funding profile compared to the initial phases of the Danish financial crisis in 2008, as the bank's loan to deposit ratio improved to 106% at year-end 2012 from 124% at year-end 2008. Hence, at year-end 2012, deposits covered just over 90% of bank loans and accounted for approximately half of Jyske Bank's total funding, largely stable from the previous year. Interbank funding remained relatively stable at 18% at year-end 2012, down from 20% at YE2011, with market funding making up the remainder. Bank deposits fell 3.7% in 2012, which Jyske Bank attributes to being less aggressive on pricing of deposits. We note that the acquired Spar Lolland will further increase the level of deposit funding due to the DKK2.6 billion deposit surplus in Spar Lolland.

Mortgage loans are largely funded via Nykredit Realkredit / Totalkredit and DLR Kredit. In 2012 Jyske Bank started a new home loan funding agreement with BRFKredit. In 2012 loans of DKK3 billion (around 1% of total assets) had been funded under this agreement with a duration of between 5 and 30 Years. Jyske Bank expects that DKK 7 - 8 billion of loans will have been funded under this agreement by end-2013. Loans funded via this new agreement with BRF are retained on Jyske Bank's balance sheet as opposed to loans funded via Nykredit Realkredit / Totalkredit and DLR Kredit.

Moody's notes that Jyske Bank has not participated in the Danish government's funding support scheme (banking package II) and that the bank was able to issue a benchmark issue of DKK3.7 billion (EUR500 million) on a standalone basis in November 2012, in addition to a similar size issue completed in 2011.

At YE2012, the bank's liquid assets stood at nearly 40% of total assets similar to 2011, giving it a satisfactory liquidity profile, since a majority of these assets can be used for repos with the central bank.

#### ASSET DETERIORATION, AND SOME CREDIT CONCENTRATION IN THE LENDING PORTFOLIO

Deteriorating credit quality resulting from the challenging macroeconomic environment in Denmark continues to have a significant impact on Jyske Bank's profitability and hence ability to absorb any additional risks in earnings and generate capital internally. However, due to the DKK1.1 billion capital increase and largely stable risk weighted assets, the capital buffer continues to increase to an adequate Tier 1 ratio of 15.3% at YE2012.

Loan loss provisions remained stable at 68% of pre-provision income in 2012 compared to 2011 indicating that new provisions continued to have a significant negative impact on the group's profitability and internal capital generation.

Loans with an objective indication of impairment increased to DKK9.4 billion (8% of gross loans) from DKK8.7 billion in 2011. Levels remain elevated compared to pre-crisis: in 2008 loans with an objective indication of impairment amounted to DKK2.7 billion or 2% of gross loans. The total balance of impairment charges and provisions equalled 49.4% of loans with objective indication of impairment in 2012, up from 44.6% in 2011.

Only around 33% of total lending and guarantees were to private individuals at YE2012, stable from YE2011, as the

mortgage loans financed via Totalkredit, Nykredit and DLR Kredit do not appear on Jyske Bank's balance sheet. Many Danish mortgage loans are originated by banks, but then transferred to specialist mortgage institutions - such as Nykredit Realkredit and DLR Kredit - in return for a periodic fee. This practice primarily reflects the funding advantage of mortgage credit institutions, due to their use of covered bond funding. As a result, mortgage institutions hold most lower-risk first-lien loans, whilst the banks, including Jyske Bank, tend to hold riskier, either second or sequential-lien, loans.

Jyske Bank's largest industry exposures include credit, finance and insurance at around 27% (including lending to subsidiaries and repo lending), real property at around 8%, manufacturing, mining, and energy at 7%, and agriculture exposures represent 4% of lending. The loan book is mainly focused on Denmark (almost 90%). The inclusion of Spar Lolland will not significantly change the structure of Jyske Bank's loan book given the much smaller size of Spar Lolland (around 5.4% of Jyske Bank's credit exposures).

Jyske Bank reports strong capitalisation ratios. At YE2012, Jyske Bank's Tier 1 ratio stood at 15.3%, with a total capital adequacy ratio of 17.3%, as calculated under transitional rules towards full Basel II. The corresponding figures at YE2011 were 13.3% and 14.7%, respectively. The increase in the capital ratios were partly driven by a DKK1.1 billion capital increase during 2012. The individual solvency requirement for the bank was 10.2% including Spar Lolland, which as of YE2012 meant the bank had a capital cushion exceeding its individual requirement of DKK7.6 billion (equivalent to 7.1% of risk weighted assets).

Moody's expect the weak macro-economic environment in Denmark will put continued pressure on the bank's profitability and limit internal capital generation. Given the continued challenges in Jyske Bank's operating environment it remains crucial for the bank to sustain a high capital buffer to mitigate any future asset deterioration. In particular, we remain concerned about exposures to sectors such as agriculture, commercial real estate and SMEs.

### **Global Local Currency Deposit Rating (Joint Default Analysis)**

Moody's assigns a global local currency deposit rating of Baa1 to Jyske Bank. In view of the bank's position in Denmark and strength in its local area of Jutland and despite its only moderate nationwide coverage, the Baa1 global local currency deposit rating receives a one-notch uplift from the baa2 BCA.

### **Notching Considerations**

Jyske Bank's junior subordinated debt and preferred stock are rated Ba1(hyb) and Ba2(hyb), respectively. These ratings are two and three notches, respectively, below Jyske Bank's baa2 adjusted standalone credit assessment (which is the same as its standalone credit assessment). The ratings do not include systemic support uplifts, reflecting Moody's view that systemic support for subordinated debt may no longer be sufficiently predictable or reliable to be a sound basis for incorporating uplift into Moody's ratings.

### **Foreign Currency Deposit Rating**

The Baa1 foreign currency deposit ratings of Jyske Bank are unconstrained given that Denmark, in common with other EU members, has a country ceiling of Aaa.

### **Foreign Currency Debt Rating**

The Baa1 foreign currency debt ratings of Jyske Bank are unconstrained given that Denmark, in common with other EU members, has a country ceiling of Aaa.

## **ABOUT MOODY'S BANK RATINGS**

### **Bank Financial Strength Rating**

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the

strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Moody's uses the Baseline Credit Assessment (BCA) to map BFSRs onto the 21-point aaa-c rating scale and like the BFSR, it reflects a bank stand-alone default risk. Each point on the aaa-c scale represents a specific probability of default and therefore allows Moody's to use the BCA as an input to Moody's Joint Default Analysis (JDA), described below. The baseline credit assessment reflects what the local currency deposit rating of the bank with the given BFSR would be without any assumed external support from a government or third party

#### Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of any external elements of support into the bank's Baseline Credit Assessment. In assigning the local currency deposit rating to a bank, the JDA methodology also factors in the rating of the various potential support providers (parent company, cooperative group, regional or national governments), as well as the degree of dependence that may exist between each one of them and the bank. Moody's assessment of the probability of systemic support (by a national government) is derived from the analysis of the capacity of a government and its central bank to provide support on a system-wide basis. The systemic support indicator is determined for a particular country and serves as an input for all bank ratings in that country. The support indicator can be set at, above or, in rare cases, below the government's local currency bond rating for that country.

#### Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

#### Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

#### About Moody's bank financial strength scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating Factors

### JYSKE BANK A/S

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Rating Factors [1]	A	B	C	D	E	Total Score	Trend
<b>Qualitative Factors (50%)</b>						<b>C</b>	
<b>Factor: Franchise Value</b>						<b>D+</b>	<b>Neutral</b>
Market share and sustainability			x				
Geographical diversification				x			
Earnings stability				x			
<b>Earnings Diversification [2]</b>							
<b>Factor: Risk Positioning</b>						<b>C+</b>	<b>Neutral</b>
<b>Corporate Governance [2]</b>							
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
<b>Controls and Risk Management</b>		x					
- Risk Management			x				
- Controls	x						
<b>Financial Reporting Transparency</b>		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information		x					
<b>Credit Risk Concentration</b>				x			
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
<b>Liquidity Management</b>			x				
<b>Market Risk Appetite</b>	x						
<b>Factor: Operating Environment</b>						<b>B</b>	<b>Neutral</b>
<b>Economic Stability</b>				x			
<b>Integrity and Corruption</b>	x						
<b>Legal System</b>	x						
<b>Financial Factors (50%)</b>						<b>C-</b>	
<b>Factor: Profitability</b>						<b>D+</b>	<b>Neutral</b>
PPI % Average RWA (Basel II)			2.43%				
Net Income % Average RWA (Basel II)				0.62%			
<b>Factor: Liquidity</b>						<b>C</b>	<b>Neutral</b>
(Market Funds - Liquid Assets) % Total Assets			2.84%				
Liquidity Management			x				
<b>Factor: Capital Adequacy</b>						<b>A</b>	<b>Neutral</b>
Tier 1 Ratio (%) (Basel II)	14.07%						
Tangible Common Equity % RWA (Basel II)	13.86%						
<b>Factor: Efficiency</b>						<b>C</b>	<b>Neutral</b>
Cost / Income Ratio			63.61%				
<b>Factor: Asset Quality</b>						<b>D</b>	<b>Weakening</b>
Problem Loans % Gross Loans				5.72%			
Problem Loans % (Equity + LLR)				36.86%			
<b>Lowest Combined Financial Factor Score (15%)</b>						<b>D</b>	
<b>Economic Insolvency Override</b>						<b>Neutral</b>	
<b>Aggregate BFSR Score</b>						<b>C</b>	
<b>Aggregate BCA Score</b>						<b>a3</b>	
<b>Assigned BFSR</b>						<b>C-</b>	
<b>Assigned BCA</b>						<b>baa2</b>	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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