

# RatingsDirect®

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## Landsbankinn hf.

**Primary Credit Analyst:**

Sean Cotten, Stockholm (46) 8-440-5928; sean.cotten@standardandpoors.com

**Secondary Contact:**

Alexander Ekbohm, Stockholm (46) 8-440-5911; alexander.ekbohm@standardandpoors.com

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# Landsbankinn hf.

<b>SACP</b>	<b>bb+</b>		+	<b>Support</b>	<b>0</b>	+	<b>Additional Factors</b>	<b>0</b>
<b>Anchor</b>	<b>bb</b>			<b>GRE Support</b>	<b>0</b>		<b>Issuer Credit Rating</b>  <b>BB+/Positive/B</b>	
<b>Business Position</b>	Adequate	<b>0</b>		<b>Group Support</b>	<b>0</b>			
<b>Capital and Earnings</b>	Strong	<b>+1</b>		<b>Sovereign Support</b>	<b>0</b>			
<b>Risk Position</b>	Adequate	<b>0</b>						
<b>Funding</b>	Average	<b>0</b>						
<b>Liquidity</b>	Adequate	<b>0</b>						

## Major Rating Factors

<b>Strengths:</b>	<b>Weaknesses:</b>
<ul style="list-style-type: none"> <li>• Very high leverage ratios and strong capital.</li> <li>• Significant liquidity buffers in relation to wholesale funding.</li> </ul>	<ul style="list-style-type: none"> <li>• Few diversification opportunities in Iceland's economy.</li> <li>• Uncertainty associated with Icelandic capital controls.</li> </ul>

## Outlook: Positive

The positive outlook on Landsbankinn hf. reflects our view that the bank's stand-alone credit profile will likely improve alongside improvements in the Icelandic economy. We see a positive trend for economic risk in the Icelandic banking sector and expect to upgrade the bank if our view of the sector continues to improve. We anticipate that Landsbankinn will improve its capital ratios and narrow the gap between its peers with respect to asset quality metrics over the next two years.

We could take a positive rating action if the bank's capital improved beyond our present forecast and it reported sustainably stronger revenues or lower credit losses than we expect. We note that Landsbankinn's capital would improve significantly above our 15% threshold for very strong capital if we revised our economic risk assessment for Iceland.

We could revise the outlook to stable if the asset quality of the bank's loan portfolio required significant additional provisioning or if valuation risk unexpectedly rose in the legacy loan book and securities portfolio. However, we have used conservative loss assumptions in our capital and earnings forecast, so we view a downgrade as unlikely at present. A situation where the sector does not continue to improve or slides into a reversal could also lead to an outlook revision to stable.

## Rationale

Standard & Poor's rating on Landsbankinn reflect our 'bb' anchor for banks operating in Iceland and our view of the bank's "adequate" business position, "strong" capital and earnings, "adequate" risk position, "average" funding, and "average" liquidity, as our criteria define these terms. The SACP is 'bb+'.

### Anchor: 'bb' for banks with an Icelandic focus, though the trend is positive

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for a commercial bank operating only in Iceland is 'bb', based on an economic risk score of '7' and an industry risk score of '6'.

Economic risk for Icelandic banks has, in our view, continued to decline. Imbalances have further declined and we expect the country's prosperous but concentrated economy to achieve annual real GDP growth of about 3% for the next two years. The banks have all undertaken significant restructuring efforts and the Icelandic economy is steadily reducing its debt burden and the banks their stock of nonperforming loans. Our view of economic risk remains constrained by the perils associated with the eventual removal of capital controls. However, our base-case scenario anticipates that the authorities will approach removing the controls in a prudent manner to minimize the impact on the economy and the Icelandic krona exchange rate.

We think industry risk has subsided following a move to a more robust regulatory system and a funding model based mainly on resident domestic deposits, in contrast with the very high dependence on external wholesale funding prior to the 2008-2009 banking crisis. We expect returns in the banking sector to be in line with those in the corporate sector and based on what we believe to be sound commercial practices.

**Table 1**

Landsbankinn hf. Key Figures					
	--Year-ended Dec. 31--				
(Mil. ISK)	2014*	2013	2012	2011	2010
Adjusted assets	1,200,392.0	1,150,931.0	1,084,246.0	1,134,801.0	1,080,256.0
Customer loans (gross)	764,508.0	731,412.0	710,117.0	667,550.0	614,076.0
Adjusted common equity	225,132.0	220,877.0	214,545.0	197,244.0	182,799.0
Operating revenues	31,031.0	55,240.0	55,981.0	55,748.0	50,500.0
Noninterest expenses	16,970.0	27,251.0	24,105.0	22,056.0	18,496.0
Core earnings	10,349.0	12,774.6	17,791.7	24,886.5	13,336.4

\*Data as of Sept. 30. ISK--Iceland krona.

### Business position: Acquisitions have aligned the bank's market position with those of its primary peers

We view Landsbankinn's business position as "adequate", reflecting its domestic market share (30%-40%) in primary business lines (corporate and retail banking, asset management, and corporate finance) and growing presence in domestic retail mortgage lending. However, the bank is relatively small, with total assets of Icelandic krona (ISK) 1.2 trillion (about €7.8 billion) in September 2014, which limits its diversification in an international context.

Landsbankinn was created in October 2008 from the domestic operations of the now defunct Landsbanki Islands hf. (LBI). As part of the transfer of LBI's domestic assets and liabilities to Landsbankinn, Landsbankinn issued a large bond to the resolution estate in 2010. In 2013, Landsbankinn issued an additional bond to compensate LBI for the increased valuation of assets Landsbankinn had received at a significant discount. The repayment schedule of these bonds was restructured in December 2014, representing a key milestone in the resolution of Iceland's capital controls and a significant development for the future stability of the bank.

In our view, Landsbankinn has been well managed since its creation in 2008. The bank also operates with significant liquidity and capital buffers and low leverage in Iceland's difficult economic environment. We take a positive view of management's proactive efforts to restructure the LBI bonds and to extend the maturity, thereby reducing short-term liquidity requirements. These bonds totaled about ISK196 billion, excluding a ISK30 billion payment made upon the final signing of the agreement.

We believe that most of Landsbankinn's near-term growth prospects lie within the domestic retail mortgage and asset finance segments. Landsbankinn has seen a rise in retail mortgage lending, which historically has been dominated by state-owned Housing Financing Fund (Ibudalanasjodur), which is expected to continue to reduce its balance sheet. This will help to diversify the bank's revenues somewhat. However, the small domestic economy limits diversification prospects, in our view.

**Table 2**

Landsbankinn hf. Business Position					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Loan market share in country of domicile	N/A	24.6	23.8	22.7	21.1
Deposit market share in country of domicile	N/A	29.4	28.2	28.9	26.3
Total revenues from business line (currency in millions)	44,574.0	75,999.0	95,435.0	120,492.0	102,971.0
Commercial banking/total revenues from business line	27.7	18.2	19.0	8.0	(4.4)
Retail banking/total revenues from business line	28.8	24.9	20.6	10.8	0.0
Commercial & retail banking/total revenues from business line	56.5	43.2	39.6	N/A	N/A
Trading and sales income/total revenues from business line	5.3	11.2	13.0	14.7	22.8
Corporate finance/total revenues from business line	N/A	N/A	N/A	0.9	0.8
Asset management/total revenues from business line	N/A	N/A	N/A	0.8	0.7
Other revenues/total revenues from business line	38.3	45.6	47.4	63.2	48.2
Investment banking/total revenues from business line	5.3	11.2	13.0	15.6	23.6
Return on equity	11.0	12.3	12.0	8.9	16.1

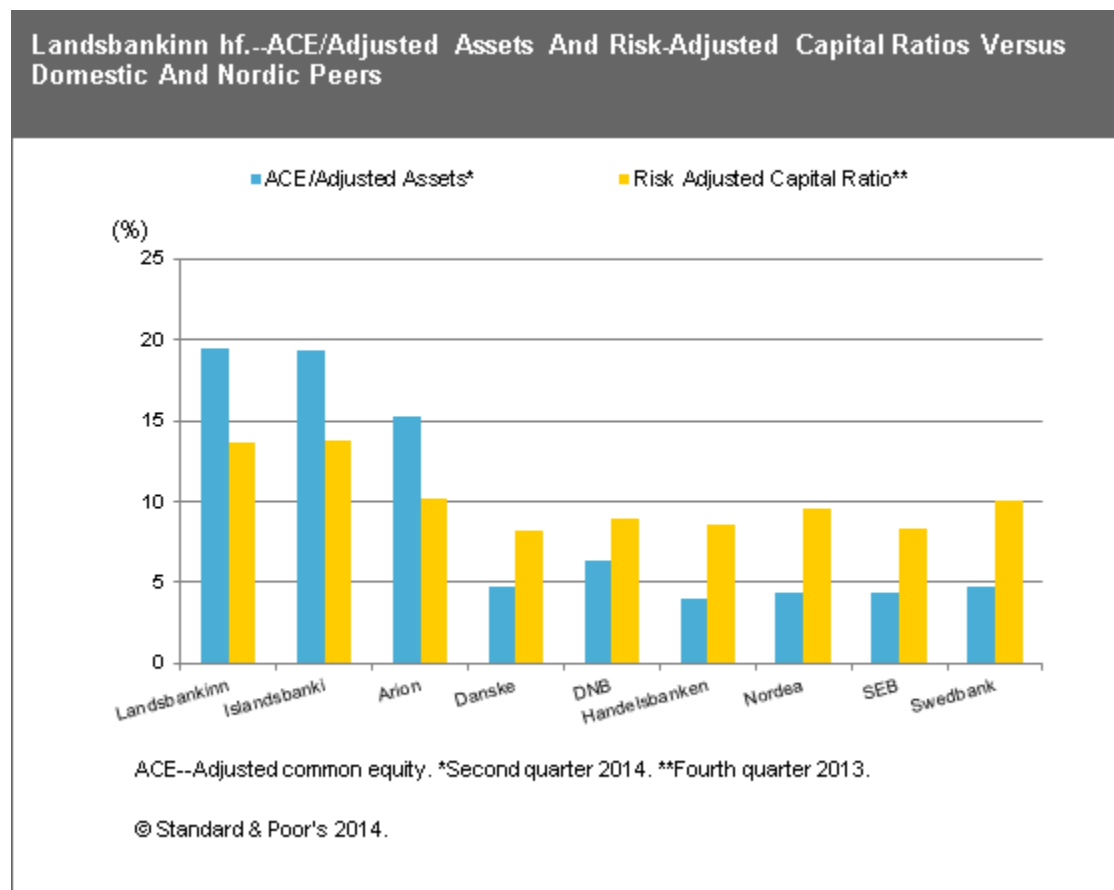
\*Data as of Sept. 30.

### Capital and earnings: Capital strong and earnings stabilizing at lower levels

We assess Landsbankinn's capital and earnings are "strong." We project the bank's risk-adjusted capital (RAC) ratio at above 15% over the next 18-24 months, after reaching 14.5% at June 2014. We expect the bank to continue to pay out most of its net profits as dividends but to improve its capital (by our measures) as legacy assets are released. We understand that initial proposals by the Icelandic banking regulator are designed to maintain high capital ratios, reducing the prospects for a significant reduction in these capital ratios (by our measures).

Landsbankinn is among the global leaders in terms of its leverage ratio (adjusted common equity to adjusted assets). The bank's share of equity is 3x-5x higher than those of its Nordic peers (see chart 1). We note that Landsbankinn's RAC ratio could improve significantly above our 15% threshold for very strong capital if there is a positive revision of Iceland's BICRA economic risk score.

**Chart 1**



We expect Landsbankinn's profits to decrease over our two-year forecast horizon as increased competition and a relative increase in mortgage lending reduce net interest margins. We also anticipate that Landsbankinn and its domestic peers will increase fee and commission income as they search for opportunities to improve revenues to offset declining valuation gains. The improvements will be temporarily absorbed by a bank tax levy used to fund debt relief for Icelandic residential borrowers, which we expect to reduce the bank's profits by ISK3 billion annually through 2016.

In the absence of one-off adjustments, we anticipate return on equity of 7%-8%, in line with the bank's domestic peers. Since its inception, Landsbankinn's profits have been boosted by improvements in the valuations of corporate loan assets acquired from LBI at a deep discount. By contract, 85% of the cumulative value improvement of the corporate loan assets was distributed to LBI in the form of a ISK92 billion bond issued in 2013 and all future valuation improvements will remain with Landsbankinn. Although Landsbankinn unexpectedly reported ISK13.5 billion in one-off valuation adjustments in the first nine months of 2014, we expect the additional impact of such revaluations to diminish over time.

The bank's earnings buffer, which measures its ability to meet normalized losses, is expected to fall to about 80 bps from over 100bps, signifying a slowdown in capital generation and reduced capacity of earnings to cover normalized losses. However, we note that figure underestimates our expectations for actual returns given that the earnings buffer calculation assumes annual normalized losses of more than ISK10 billion, a level we expect the bank to exceed throughout our two-year forecast period as asset quality in Iceland improves.

**Table 3**

<b>Landsbankinn hf. 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	27.5	27.1	25.5	21.9	20.0
S&P RAC ratio before diversification	N.M.	13.7	12.5	N.M.	N.M.
S&P RAC ratio after diversification	N.M.	11.1	10.2	N.M.	N.M.
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Double leverage	N.M.	N.M.	N.M.	N.M.	N.M.
Net interest income/operating revenues	71.9	62.1	63.6	58.6	48.9
Fee income/operating revenues	13.5	9.6	7.9	7.9	7.1
Market-sensitive income/operating revenues	10.0	20.4	21.2	31.8	46.6
Noninterest expenses/operating revenues	54.7	49.3	43.1	39.6	36.6
Preprovision operating income/average assets	1.6	2.5	2.9	3.0	3.0
Core earnings/average managed assets	1.2	1.1	1.6	2.2	1.2

\*Data as of Sept. 30. N.M.--Not meaningful.

**Table 4**

<b>Landsbankinn hf. Risk-Adjusted Capital Framework Data</b>					
<b>(Mil. ISK)</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	230,459	8,050	3	108,364	47
Institutions	67,621	28,275	42	59,225	88
Corporate	440,821	388,863	88	659,445	150
Retail	270,558	161,638	60	270,495	100
Of which mortgage	140,511	67,950	48	89,759	64
Securitization	0	0	0	0	0
Other assets	64,045	64,325	100	135,448	211
Total credit risk	1,073,504	651,150	61	1,232,976	115
<b>Market risk</b>					
Equity in the banking book¶	4,228	0	0	52,850	1,250
Trading book market risk	--	105,525	--	158,288	--
Total market risk	--	105,525	--	211,138	--
<b>Insurance risk</b>					
Total insurance risk	--	--	--	0	--

Table 4

## Landsbankinn hf. Risk-Adjusted Capital Framework Data (cont.)

<b>Operational risk</b>					
Total operational risk	--	104,500	--	104,966	--
<b>(Mil. ISK)</b>	<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	861,175		1,549,080		100
Total adjustments to RWA	--		355,909		23
RWA after diversification	861,175		1,904,989		123
<b>(Mil. ISK)</b>	<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	230,999	26.8	225,179	14.5	
Capital ratio after adjustments§	230,999	26.8	225,179	11.8	

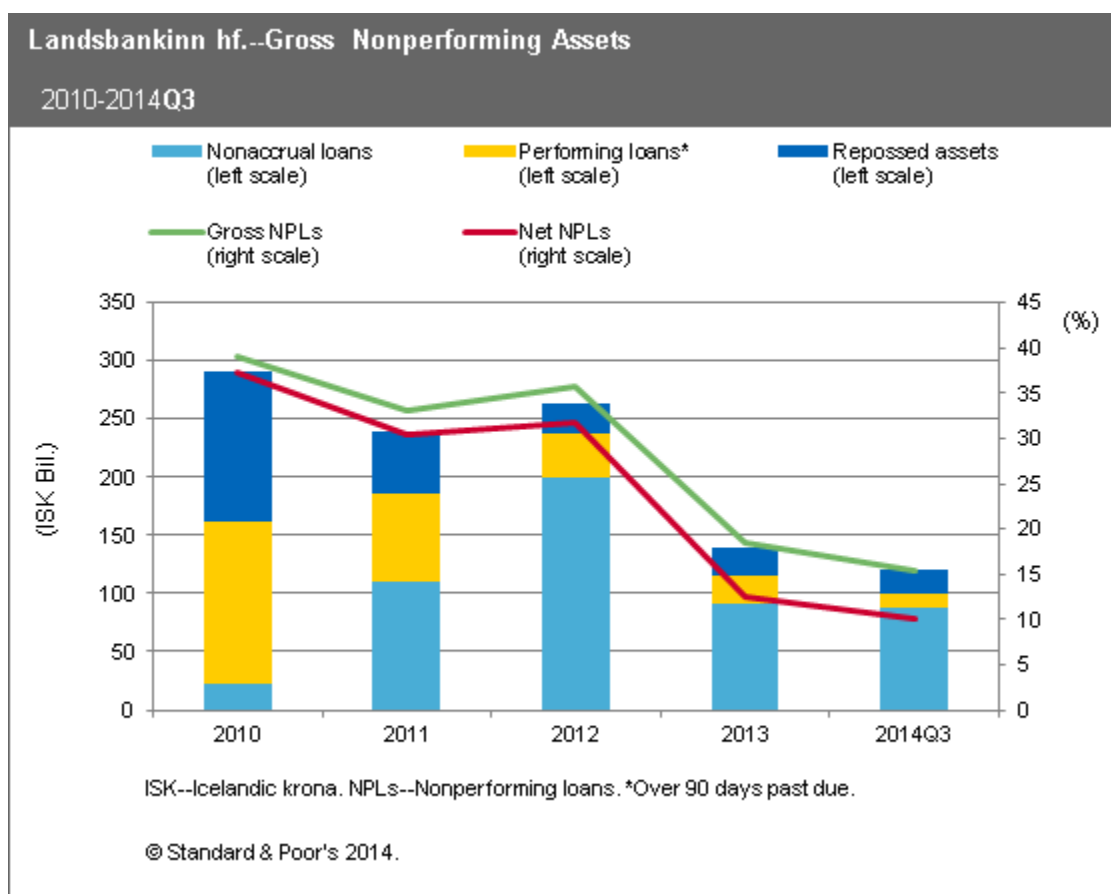
\*Exposure at default. €Securitization exposure includes securitization tranches deducted from capital in the regulatory framework. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. ISK--Iceland krona. Sources: Company data as of June. 30, 2014, Standard & Poor's.

**Risk position: Asset quality metrics expected to show further improvement**

In our view, Landsbankinn's "adequate" risk position reflects its large retail and corporate market share. Given Landsbankinn's exposure profile, which covers broad spectrum of the bank's domestic exposures, we expect the bank's risk position to remain highly correlated to our assessment of domestic economic risk.

In September 2014, Landsbankinn's gross non-performing assets (including non-accrual loans, performing loans over 90 days past due, and repossessed assets) stood at 15.3% of customer loans and repossessed assets. Significant reduction in past due and repossessed assets continues, while reduction in nonaccrual loans has slowed in 2014 (see chart 2). Nonperforming loans continue to fall, from levels as high as 35.8% as recently as the end of 2012. Net of loss reserves, non-performing loans stood at 10.1% in September 2014, indicating loss reserve coverage of 37%. While higher than those of Landsbankinn's domestic peers, we anticipate that the bank will close the gap further in 2015 and 2016 as legal disputes over foreign exchange-linked loans with selected large corporates are resolved.

Chart 2



In the first three quarters of 2014, Landsbankinn had net reversals of ISK484 million, compared with new impairments of ISK8.5 billion during the corresponding period of 2013. We note that some counterparties' restructurings or defaults are currently subject to legal proceedings and expect provisions to be somewhat volatile over the next two years, but to continue to decline on average from end-2013 levels. Likewise, we believe any remaining positive revaluations of the loan book will be more limited, with the potential exception of a few large counterparties.

We do not presently anticipate Landsbankinn will incur significant losses as a result of ongoing litigation with respect to a single consumer price indexed loan. In November 2014, the European Free Trade Association (EFTA) Surveillance Authority said it was for an Icelandic court to decide whether the bank's ex-ante assumption of a 0% inflation rate was appropriate, but that in its opinion the practice was incompatible with a European Consumer Credit Directive given that the bank understated the cost of credit when compared with realistic inflation assumptions. The case will now be tried in an Icelandic court. We understand that there is still considerable uncertainty about the legal process and will continue to monitor proceedings.



Table 5

Landsbankinn hf. Risk Position					
	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Growth in customer loans	6.0	3.0	6.4	8.7	(9.0)
Total diversification adjustment / S&P RWA before diversification	N.M.	22.6	22.1	N.M.	N.M.
Total managed assets/adjusted common equity (x)	5.3	5.2	5.1	5.8	5.9
New loan loss provisions/average customer loans	(0.1)	1.1	1.8	1.1	2.3
Net charge-offs/average customer loans	1.0	0.1	0.1	0.3	(0.0)
Gross nonperforming assets/customer loans + other real estate owned	15.3	18.5	35.8	33.2	39.1
Loan loss reserves/gross nonperforming assets	37.5	36.4	16.7	11.9	7.3

\*Data as of Sept. 30. N.M.--Not meaningful.

### Funding and liquidity: Strong liquidity, even considering potential outflows of foreign currency deposits

We consider Landsbankinn's funding to be "average," balancing the bank's relatively strong funding metrics against its relatively high share of wholesale funding and short-term bank deposits. Using pro rata September 2014 figures, adjusted for the LBI bond restructuring, we estimate that the LBI bonds comprise about 22% of Landsbankinn's funding base and bank deposits an additional 20%. Notably, the bank's short-term funding is about 3x higher than that of its domestic peers. We believe that Landsbankinn will seek additional wholesale funding from the capital markets as the LBI bonds are repaid, thereby remaining somewhat more reliant on wholesale funding than its domestic peers.

The new terms of the LBI bond agreement represent a significant improvement in Landsbankinn's debt maturity profile. Landsbankinn paid ISK30 billion when the agreement entered effect in December 2014, lowering the outstanding amount to ISK196 billion. Large bond repayments that were due from 2015-2018 will be replaced by smaller tranches of ISK30 billion maturing every second year from 2016 to 2026, apart from 2018 when ISK40 billion will be repaid (see chart 3). As of Sept. 30, 2014, Landsbankinn's stable funding ratio was 113%, by our measures. We estimate the pro rata ratio at 110% assuming a ISK33 billion reduction in liquid assets and the LBI bonds in the fourth quarter of 2014, and an elimination of issued debt due within one year. We do not consider the restructuring to be a distressed exchange or a default in view of the bilateral agreement between Landsbankinn and LBI to extend the repayment terms.

We consider Landsbankinn's liquidity as "adequate", even after the restructuring of the LBI bonds. In September 2014, Landsbankinn's ratio of broad liquid assets to short-term wholesale funding was 1.7x and our pro rata estimate following the bond restructuring is 1.9x. The bank's domestic peers demonstrate a relative advantage in terms of liquidity, in our view. At end-2013, Arion Bank's ratio of broad liquid assets to short-term wholesale funding was 4.8x and Islandsbanki's was 3.5x.

Given the prospects of an eventual relaxation of capital controls in Iceland, it is important to have exceptional funding and liquidity buffers, particularly in foreign currency. At end-September 2014, Landsbankinn's liquid foreign currency assets (ISK173.5 billion) exceeded its foreign currency deposits (ISK161.6 billion), a large share of which is associated with LBI's winding up entity. However, we expect Landsbankinn to continue to build its liquid foreign currency buffer given a scheduled ISK33 billion outflow for LBI bond repayment in the fourth quarter of 2014.

Chart 3

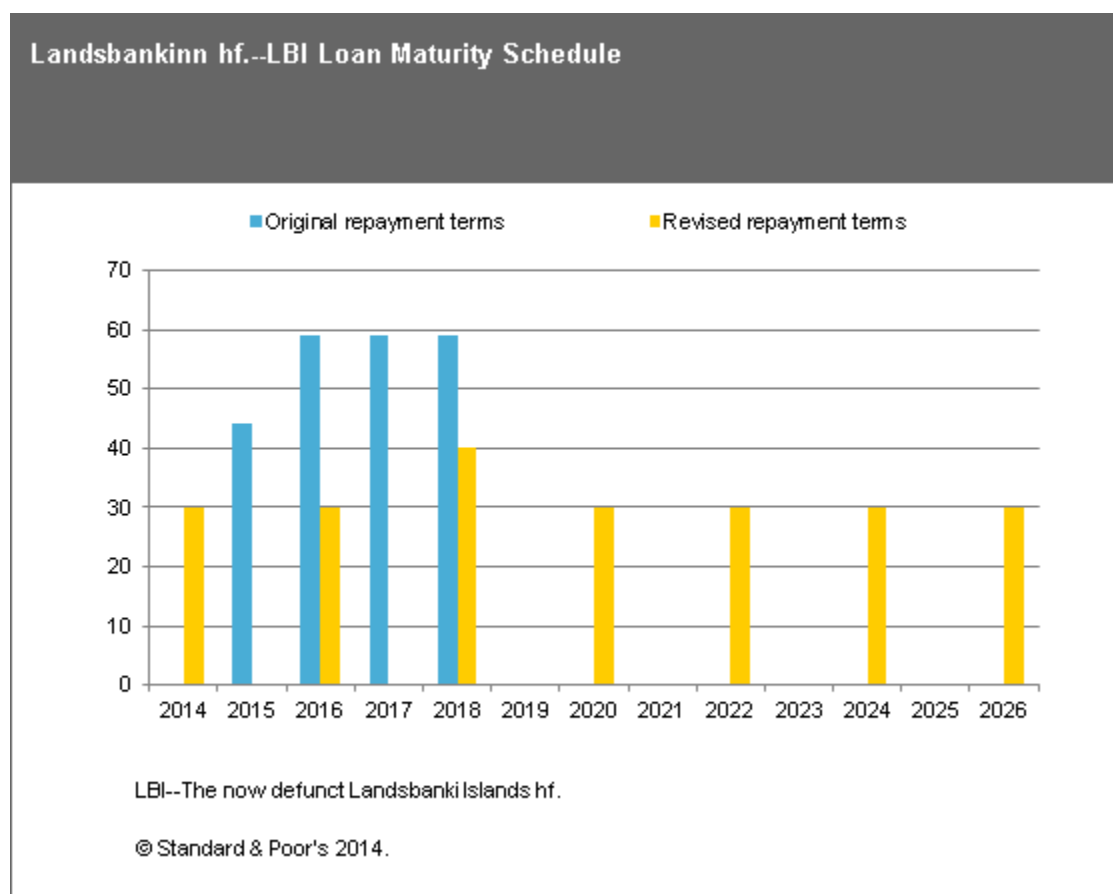


Table 6

### Landsbankinn hf. Funding And Liquidity

	--Year-ended Dec. 31--				
(%)	2014*	2013	2012	2011	2010
Core deposits/funding base	54.3	52.5	50.2	49.1	45.7
Customer loans (net)/customer deposits	144.6	149.0	158.2	144.1	159.6
Long term funding ratio	80.3	82.4	89.4	88.3	84.0
Stable funding ratio	112.9	115.1	119.9	117.7	105.3
Short-term wholesale funding/funding base	24.9	22.4	13.4	14.3	19.7
Broad liquid assets/short-term wholesale funding (x)	1.7	1.8	2.6	2.4	1.8
Net broad liquid assets/short-term customer deposits	33.0	38.1	46.6	43.6	36.7
Short-term wholesale funding/total wholesale funding	54.4	47.2	26.9	28.1	36.2
Narrow liquid assets/3-month wholesale funding (x)	2.0	1.9	2.5	2.5	1.6

\*Data as of Sept. 30.

### External support: Government support for Icelandic banks is uncertain

Landsbankinn is 98% owned by the Icelandic government. Although we regard the bank as having "high" systemic importance, we add no notches of uplift to the SACP because future extraordinary government support is uncertain, in

our view. This view reflects the Icelandic government's historical lack of support for senior creditors and improved but still limited capacity to support the country's new, smaller banking system in the event of severe stress.

### Additional rating factors: None

No additional factors affect the ratings.

## Related Criteria And Research

### Related Criteria

- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, Feb. 26, 2013
- 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

- Outlooks For Iceland's Top 3 Banks Revised To Positive On Our More Favorable View Of The Economy, Oct. 14, 2014
- Banking Industry Country Risk Assessment: Iceland, Dec. 10, 2014
- Iceland-Based Landsbankinn Assigned 'BB+/B' Ratings; Outlook Stable, Jan. 20, 2014

### Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

### Ratings Detail (As Of December 22, 2014)

#### Landsbankinn hf.

Counterparty Credit Rating	BB+/Positive/B
Senior Unsecured	BB+
Short-Term Debt	B

#### Counterparty Credit Ratings History

14-Oct-2014	BB+/Positive/B
20-Jan-2014	BB+/Stable/B

**Ratings Detail (As Of December 22, 2014) (cont.)**

**Sovereign Rating**

Iceland (Republic of)

BBB-/Positive/A-3

\*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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