

Research

Landsbankinn hf.

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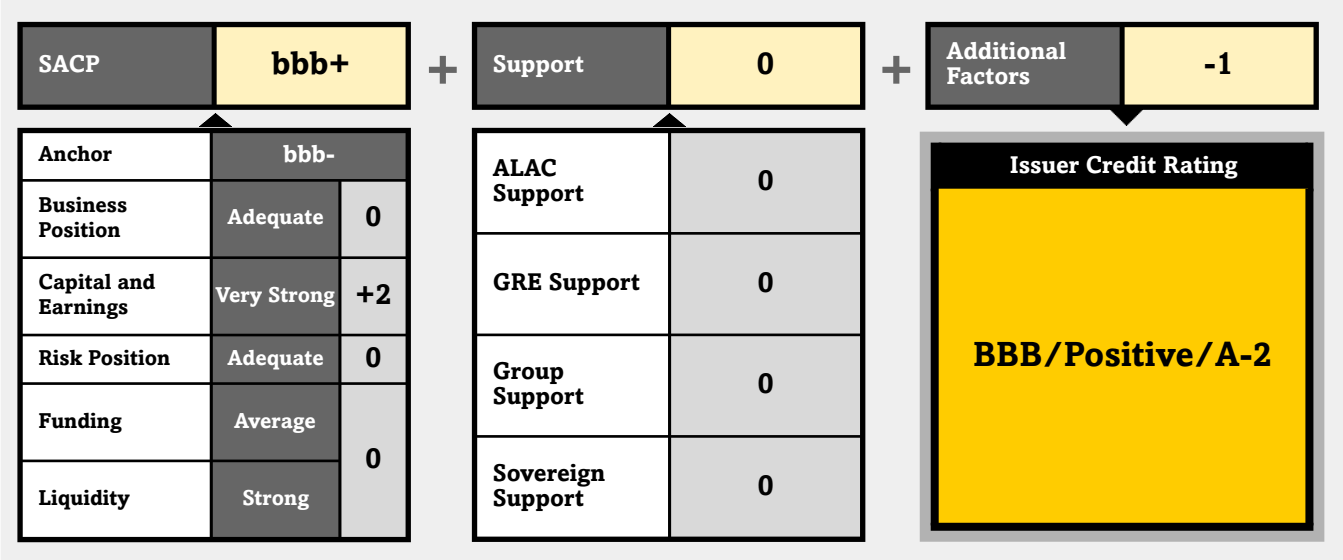
Major Rating Factors

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Related Criteria And Research

Landsbankinn hf.



Major Rating Factors

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

Outlook: Positive

The positive outlook on Landsbankinn hf. reflects S&P Global Ratings' view of continued improvement in the operating environment for Icelandic banks. It also mirrors our expectations that the bank's risk-adjusted capital (RAC) ratio will remain above 15% over the next two years, despite extraordinary dividends and share buy-back programs. However, we note that this scenario is only our base case, and uncertainty around Landsbankinn's optimization of capitalization remains.

We could take a positive rating action if we see a further strengthening of operating conditions for banks in Iceland. We could also raise our rating on Landsbankinn if we become more certain about future capitalization, prompting us to remove the negative notch we currently apply to reflect our uncertainty in this regard, in addition to questions about the bank's future ownership. Despite continued positive trends for the Icelandic banking sector, given the relatively concentrated and volatile nature of the Icelandic economy, we do not anticipate a two-notch upgrade over the next two years.

We could revise the outlook to stable if we see signs of a weakening of the strong economic development in Iceland or an increased risk of economic imbalances in the economy. We could also revise the outlook to stable if Landsbankinn's capital levels declined more than we expect.

Rationale

Our rating on Landsbankinn reflects our 'bbb-' anchor for banks operating in Iceland, and our view of the bank's adequate business position, very strong capital and earnings, adequate risk position, average funding, and strong liquidity. Our assessment of Landsbankinn's stand-alone credit profile (SACP) is 'bbb+'. We apply a negative notch to the rating due to the uncertainty associated with Landsbankinn's future ownership and its impact on capital policy.

Anchor: 'bbb-' for banks operating primarily in Iceland

We use our Banking Industry Country Risk Assessment's 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 'bbb-', based on an economic risk score of '5' and an industry risk score of '5'.

Economic risk for Icelandic banks has, in our view, declined gradually, and we believe the 2008 financial crisis has largely worked its way through the banking system, as reflected by the banks' loan loss ratio at 15 basis points (bps) systemwide and private sector credit below 150% of GDP in 2015. In addition, we believe that economic resilience in Iceland is strengthening, as reflected by the trends of rising housing prices, strong economic growth, and low unemployment. With the recent auctions of Icelandic krona, we think the risk for a shock to the banking industry related to the currency overhang and removal of capital controls has decreased meaningfully. Although there is progress, the last steps in removing the capital controls still create some uncertainty in the Icelandic economy in the near term.

We think industry risk has subsided following a move to a stronger regulatory system and an improved funding model based on domestic deposits and covered bonds, and significant equity levels, as well as improved access to foreign wholesale funding for the Icelandic banks. We expect returns will be based on what we believe to be sound commercial practices. Substantial one-off items have inflated the banks' profits over the past few years, but we expect future impact will be contained.

Table 1

Landsbankinn hf. Key Figures					
	--Year-ended Dec. 31--				
(Mil. ISK)	2016*	2015	2014	2013	2012
Adjusted assets	1,131,517.0	1,116,646.0	1,097,145.0	1,150,931.0	1,084,246.0
Customer loans (gross)	860,695.0	845,206.0	759,802.0	731,412.0	710,117.0
Adjusted common equity	232,471.0	234,019.0	225,891.0	220,877.0	214,545.0
Operating revenues	37,273.0	54,395.0	43,486.0	55,240.0	55,981.0
Noninterest expenses	17,582.0	23,732.0	24,088.0	27,251.0	24,105.0
Core earnings	16,400.0	26,788.2	14,682.7	12,774.6	17,791.7

*Data as of Sept. 30. ISK--Icelandic krona.

Business position: Largest Icelandic bank with increasing business diversification

We believe Landsbankinn's business position will remain adequate, reflecting its market share (30%-40%) in primary business lines (corporate and retail banking, asset management, and corporate finance). Landsbankinn has traditionally

been the leading corporate bank of Iceland, but over the past few years it has expanded into the domestic retail mortgage space, mainly by taking shares from the state-owned Housing Financing Fund (HFF). As such, Landsbankinn has reached a share just below 20% of the Icelandic mortgage market, similar to its two main peers, Arion Bank and Islandsbanki. However, the bank is relatively small in an international context, with total assets of Icelandic krona (ISK) 1.1 trillion (about €8.6 billion) at end-September 2016, and a domestic focus that limits its diversification prospects given the nature of the Icelandic market.

In our view, Landsbankinn has been well managed since its creation in 2008, when it was formed from the domestic operations of the now defunct Landsbanki Islands hf (LBI). The bank continues to operate with significant liquidity and capital buffers and low leverage. Also, we take a positive view of management's proactive efforts to prepay the LBI bonds and to achieve normalcy in the bank's funding profile. The bank has amended its strategy over the past year, including initiatives to increase efficiency. The bank has no public policy role and the government is not involved in its management and strategy, despite the 98.2%-ownership share held by the Icelandic government.

The government still plans to reduce its stake in the bank to 70%, but due to the off-cycle elections this past October, spurred by the revelation of the Panama Papers, the sales process has been held up, and we do not expect any material divestments over the next 12 months. We believe the government will withdraw its ownership from Landsbankinn in stages. Because the government is not involved in the bank's strategy and has not given Landsbankinn any policy role, we assume that the government does not intend to hold a majority stake in the bank in the longer term.

Table 2

Landsbankinn hf. Business Position					
	--Year-ended Dec. 31--				
(%)	2016*	2015	2014	2013	2012
Loan market share in country of domicile	N/A	N/A	25.3	24.6	23.8
Deposit market share in country of domicile	N/A	N/A	34.2	29.4	28.2
Total revenues from business line (mil. ISK)	37,273.0	68,171.0	63,496.0	75,999.0	95,435.0
Commercial banking/total revenues from business line	31.9	21.2	25.3	18.2	19.0
Retail banking/total revenues from business line	37.0	27.4	28.4	24.9	20.6
Commercial & retail banking/total revenues from business line	68.9	48.6	53.8	43.2	39.6
Trading and sales income/total revenues from business line	8.4	8.1	6.6	11.2	13.0
Other revenues/total revenues from business line	22.7	43.3	39.6	45.6	47.4
Investment banking/total revenues from business line	8.4	8.1	6.6	11.2	13.0
Return on equity	8.5	14.2	12.1	12.3	12.0

*Data as of Sept. 30. ISK--Icelandic krona. N/A--Not applicable.

Capital and earnings: Very strong capital despite extraordinary dividends

We view Landsbankinn's capital and earnings as very strong. The RAC ratio as of end-June 2016 was 16.5%. Because of our view of improved economic risk in Iceland, and thus lower risk-weights, however, our pro forma RAC ratio at the same date is 18.6%.

We expect Landsbankinn will continue to pay out most of its net profits as dividends, with the potential for extraordinary dividends. Furthermore, in September 2016, the bank announced a share buy-back of a maximum of 480

million shares, or the equivalent of 2% of issued share capital. While, as per our base case, we project that Landsbankinn's RAC ratio will remain above 16% over the next two years, we see uncertainty about its capitalization in the longer term, given our anticipation that the bank and its domestic peers will seek to optimize their capital bases owing to the high leverage ratios (compared with its international peers) and efforts to have more attractive returns on equity for potential investors.

We note that Landsbankinn's 28.9% capital ratio as of June 30, 2016, comprised entirely of common equity, remains well above the 22.1% requirements at year-end 2015. Furthermore, the bank has an outstanding leverage ratio compared with its Nordic peers. Landsbankinn's profits have been volatile due to a large impact from revaluations of financial assets and legacy loans acquired at deep discounts, as well as loan loss reversals. We expect these impacts to be small going forward, and anticipate that core earnings to equity will stabilize around 7% over our two-year forecast. We expect a stable net interest margin, given the high pressure on margins due to increased competition and a relative increase in mortgage lending would be offset by lower funding costs as the bank continues to prepay LBI bonds from cheaper market funding. We anticipate that Landsbankinn and its domestic peers will increase fee and commission income as they search for opportunities to strengthen revenues to offset declining valuation gains. The temporary bank tax levy used to fund debt relief for Icelandic residential borrowers has been extended and could become permanent.

We expect Landsbankinn's earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, will remain adequate, above 100 bps, despite a decrease as the boost from revaluations diminishes.

Chart 1

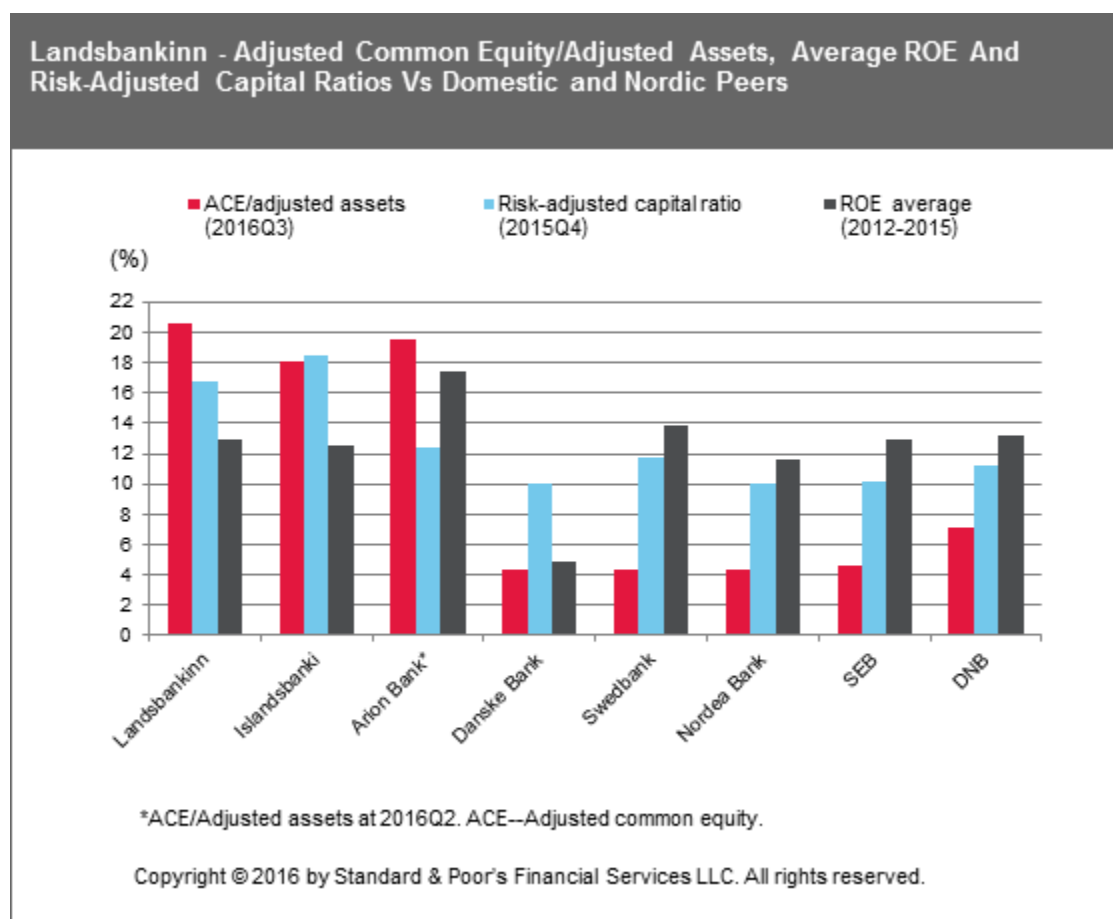


Table 3

Landsbankinn hf. Capital And Earnings

(%)	--Year-ended Dec. 31--				
	2016*	2015	2014	2013	2012
Tier 1 capital ratio	29.1	30.3	29.5	27.1	25.5
S&P RAC ratio before diversification	N.M.	16.8	14.1	13.7	12.5
S&P RAC ratio after diversification	N.M.	13.1	11.1	11.1	10.2
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	70.3	59.4	64.6	62.1	63.6
Fee income/operating revenues	15.9	12.6	13.4	9.6	7.9
Market-sensitive income/operating revenues	2.2	21.0	12.6	20.4	21.2
Noninterest expenses/operating revenues	47.2	43.6	55.4	49.3	43.1
Provision operating income/average assets	2.3	2.8	1.7	2.5	2.9
Core earnings/average managed assets	1.9	2.4	1.3	1.1	1.6

*Data as of Sept. 30. RAC--Risk-adjusted capital. N/A--Not applicable. N.M.--Not meaningful.

Table 4

Landsbankinn hf. Risk-Adjusted Capital Framework Data					
(Mil. ISK)	Exposure*	Basel II RWA	Average Basel II RW (%)	S&P Global Ratings' RWA	Average S&P Global Ratings' RW (%)
Credit risk					
Government and central banks	175,141	5,550	3	52,809	30
Institutions	23,955	7,525	31	6,725	28
Corporate	526,091	468,163	89	639,243	122
Retail	359,164	196,413	55	279,340	78
Of which mortgage	223,357	98,788	44	119,340	53
Securitization§	0	0	0	0	0
Other assets	64,392	60,675	94	115,878	180
Total credit risk	1,148,743	738,325	64	1,093,995	95
Market risk					
Equity in the banking book†	18,394	0	0	195,353	1,062
Trading book market risk	--	15,963	--	23,944	--
Total market risk	--	15,963	--	219,296	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	95,838	--	104,015	--
(Mil. ISK)		Basel II RWA		S&P Global Ratings' RWA	% of S&P Global Ratings' RWA
Diversification adjustments					
RWA before diversification	--	850,125	--	1,417,306	100
Total Diversification/Concentration Adjustments	--	--	--	405,377	29
RWA after diversification	--	850,125	--	1,822,684	129
(Mil. ISK)		Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global Ratings' RAC ratio (%)
Capital ratio					
Capital ratio before adjustments	--	245,163	28.8	233,876	16.5
Capital ratio after adjustments‡	--	245,163	28.8	233,876	12.8

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' 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--Icelandic krona. Sources: Company data as of June. 30, 2016, S&P Global Ratings.

Risk position: Improving asset quality and economic environment

In our view, Landsbankinn's adequate risk position reflects its large market share in retail and small and midsized enterprises (SME). Given Landsbankinn's exposure profile, which covers a broad spectrum of the domestic exposures and industries, we expect the bank's risk position will remain highly correlated to the domestic economy.

Landsbankinn's asset quality has improved as the Icelandic economy has recovered from the crisis, and the bank reported material net impairment reversal in 2015 and the first three quarters of 2016. The reversals are connected to over-provisioning for legacy assets, and we expect only minor repercussions going forward. As such, we expect normalized levels of new credit losses at about 30 bps over the coming two years, though one-off recoveries could create volatility.

Gross nonperforming assets (NPAs) were 5.57% of customer loans and repossessed assets as of Sept. 30, 2016, down from 8.33% at year-end 2015 and a high 36% in 2012. While the bank's NPAs have historically been higher than domestic peers', in part due to the higher share of SME lending, we see the gaps closing as Islandsbanki and Arion had NPAs of 5.13% and 5.28%, respectively, which are only marginally lower than that of Landsbankinn.

We note an increasing share of lending to construction companies, which are generally more sensitive to swings in the economic development compared with other industries in Landsbankinn's portfolio. Real estate construction slowed down markedly in the first couple of years following the financial crisis, but the industry is now growing as the demand for new real estate is high, driven by a young population and the booming tourism. We expect that Landsbankinn's lending to construction companies will remain around current levels (7% of total loans) over the next two years.

Chart 2

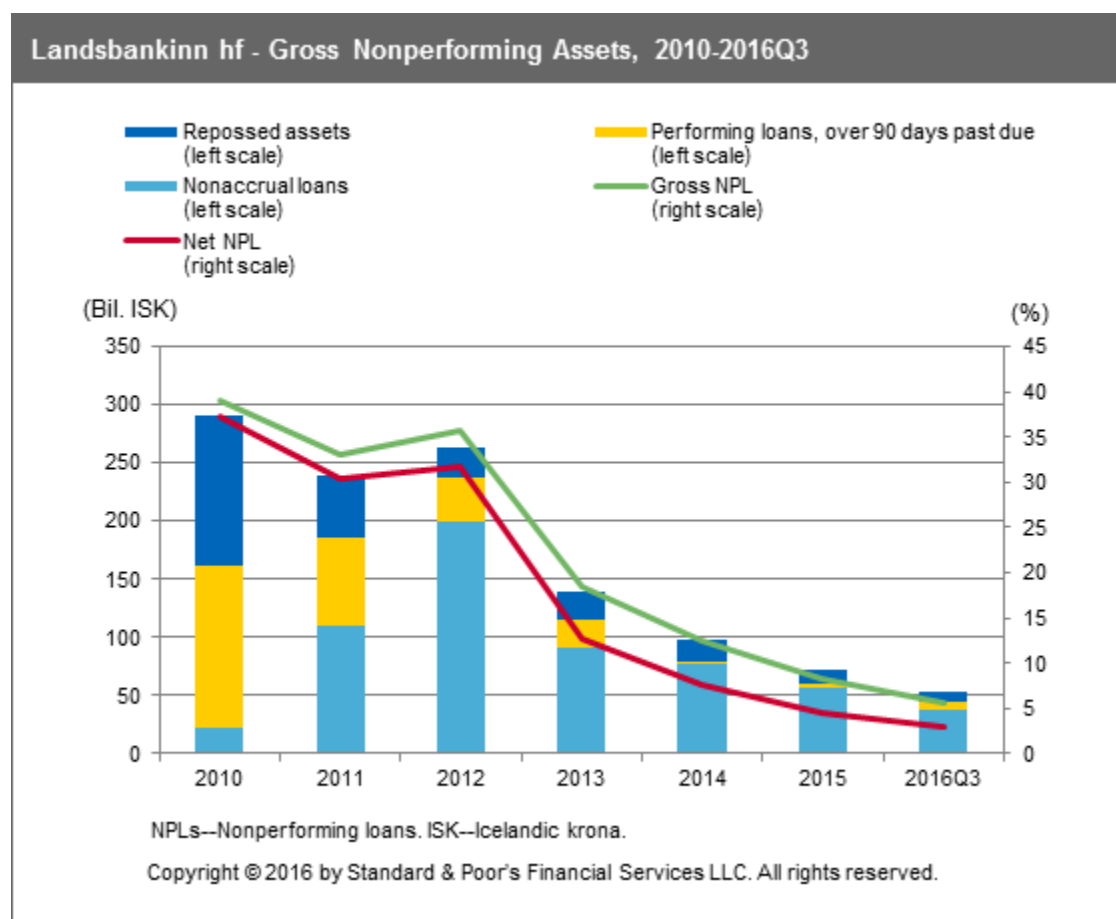


Table 5

Landsbankinn hf. Risk Position	--Year-ended Dec. 31--				
	2016*	2015	2014	2013	2012
(%)					
Growth in customer loans	2.4	11.2	3.9	3.0	6.4
Total diversification adjustment / S&P RWA before diversification	N.M.	28.6	26.9	22.6	22.1
Total managed assets/adjusted common equity (x)	4.9	4.8	4.9	5.2	5.1
New loan loss provisions/average customer loans	(0.7)	(0.6)	0.0	1.1	1.8
Net charge-offs/average customer loans	0.9	0.7	1.6	0.1	0.1
Gross nonperforming assets/customer loans + other real estate owned	5.6	8.3	12.5	18.5	35.8
Loan loss reserves/gross nonperforming assets	48.0	47.1	42.5	36.4	16.7

*Data as of Sept. 30. RWA--Risk-weighted assets. N.M.--Not meaningful.

Funding and liquidity: Strong liquidity, despite outflows of deposits

We consider Landsbankinn's funding to be average, balancing the bank's relatively strong funding metrics against continued uncertainties of deposit withdrawals related to the capital control liberalization. We also consider the metrics slightly overstated as the bank has only recently gained access to wholesale funding, and as such has yet to reach a normalized maturity distribution.

We view positively Landsbankinn's improved access to wholesale funding, both on the domestic covered bond market and on foreign bond markets. They have issued bonds of a value just below €900 million in euros and Scandinavian currencies since October 2015, of which €500 million in a single issue in September 2016. The proceeds from these issues have mainly been used to prepay around €820 million of the LBI bond in total, but also to increase liquidity. We believe that also new foreign wholesale funding will mainly be used to refinance current, more expensive bonds and will not support domestic assets. Given current funding spreads, we anticipate that Landsbankinn will aim to fully replace its legacy LBI bonds with market funding by the end of 2017.

On Oct. 11, 2016, private investors were authorized to invest up to ISK30 million (approximately €0.25 million) abroad, and in January 2017 the limit is lifted to ISK100 million (€0.82 million). While we do expect a resulting outflow of deposits, we do not expect any substantial impact on Landsbankinn's funding or liquidity metrics.

Landsbankinn's stable funding ratio was at 114.9% at end-June 2016, (against a high of 129% at end-June 2015), which was in line with our expectations, and we believe it to remain solid in the coming years. The ratio compares well to international peers. As of Sept. 30, 2016, Landsbankinn had a net stable funding ratio (NSFR) of 149% for foreign currency, comfortably above the regulatory minimum of 90%.

We consider Landsbankinn's liquidity as strong, as broad liquid assets covered short-term wholesale funding by 4.4x in September 2016, despite considerable deposit outflow. We anticipate a limited impact from future deposit flows, and expect the ratio to remain high over the next two years. Landsbankinn's liquidity coverage ratio (LCR) was 140%, for foreign currency 594%, as of Sept. 30, 2016--both comfortably above the regulatory requirement of 90% and 100%, respectively.

Table 6

Landsbankinn hf. Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2016*	2015	2014	2013	2012
Core deposits/funding base	68.9	67.5	67.5	52.5	50.2
Customer loans (net)/customer deposits	143.5	145.2	130.3	149.0	158.2
Long term funding ratio	95.2	93.5	93.9	82.4	89.4
Stable funding ratio	114.9	115.7	121.9	115.1	119.9
Short-term wholesale funding/funding base	6.2	8.6	7.9	22.4	13.4
Broad liquid assets/short-term wholesale funding (x)	4.4	3.4	4.4	1.8	2.6
Net broad liquid assets/short-term customer deposits	30.8	32.6	40.8	38.1	46.6
Short-term wholesale funding/total wholesale funding	20.0	26.3	24.3	47.2	26.9
Narrow liquid assets/3-month wholesale funding (x)	4.7	4.8	4.7	1.9	2.5

*Data as of Sept. 30.

External support: No notches of uplift to the SACP

We expect that the government will gradually decrease its ownership stake in Landsbankinn, currently 98.2%. There is currently a mandate for the government to reduce its stake to 70%, a level that could be reduced further over the long term. As such, we do not consider Landsbankinn to be a strategic government-related entity for Iceland. Although we regard the bank as having high systemic importance, we add no uplift to the SACP because future extraordinary government support is uncertain, in our view. This view reflects the Icelandic government's track record of not providing support for senior creditors and its improved, but still limited, capacity to support the country's new, smaller banking system in the event of severe financial stress.

At present, we do not regard the bank resolution framework as effective. As such, for our ratings on Icelandic banks, we do not consider additional loss-absorbing capacity (see "Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity," published April 27, 2015, on RatingsDirect). We regard the current framework as open ended but, in our view, the authorities' method of dealing with failing banks so far indicates a tendency to safeguard depositors rather than senior unsecured creditors. Over the next two to three years, we expect Iceland to implement a framework similar to the EU's Banking Recovery And Resolution Directive and, with it, bail-in powers that could lead us to change our view.

Additional rating factors: A one- notch deduction for uncertainty regarding ownership change

In our view, a potential IPO is likely to require the recalibration of Landsbankinn's current capital and leverage levels. This adds an element of uncertainty to our base-case capital projections, and we therefore apply a negative adjustment to the rating. As such, our counterparty credit rating on Landsbankinn is one notch lower than the 'bbb+' SACP.

Related Criteria And Research

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015

- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework - June 22, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Landsbankinn Upgraded To 'BBB/A-2' On Improved Operating Conditions In Iceland And Stronger Capital; Outlook Positive - October 25, 2016
- Various Positive Rating Actions On Four Icelandic Banks On Receding Economic Risks and Improved Access To Funding - October 25, 2016
- Nordic Banks' Capital Growth Tapers Off - August 02, 2016
- The Future Of Banking: Nordic Banks Looking Svelte In The Fintech Race - June 14, 2016
- Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable - July 15, 2016

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 November 30, 2016)

Landsbankinn hf.

Counterparty Credit Rating	BBB/Positive/A-2
Senior Unsecured	BBB
Short-Term Debt	A-2

Counterparty Credit Ratings History

25-Oct-2016	BBB/Positive/A-2
21-Jul-2015	BBB-/Positive/A-3
14-Oct-2014	BB+/Positive/B
20-Jan-2014	BB+/Stable/B

Ratings Detail (As Of November 30, 2016) (cont.)

Sovereign Rating

Iceland (Republic of)

BBB+/Stable/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' 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.

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