

RatingsDirect®

Landsbankinn hf.

Primary Credit Analyst:

Antonio Rizzo, Madrid (34) 91-788-7205; Antonio.Rizzo@spglobal.com

Secondary Contact:

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

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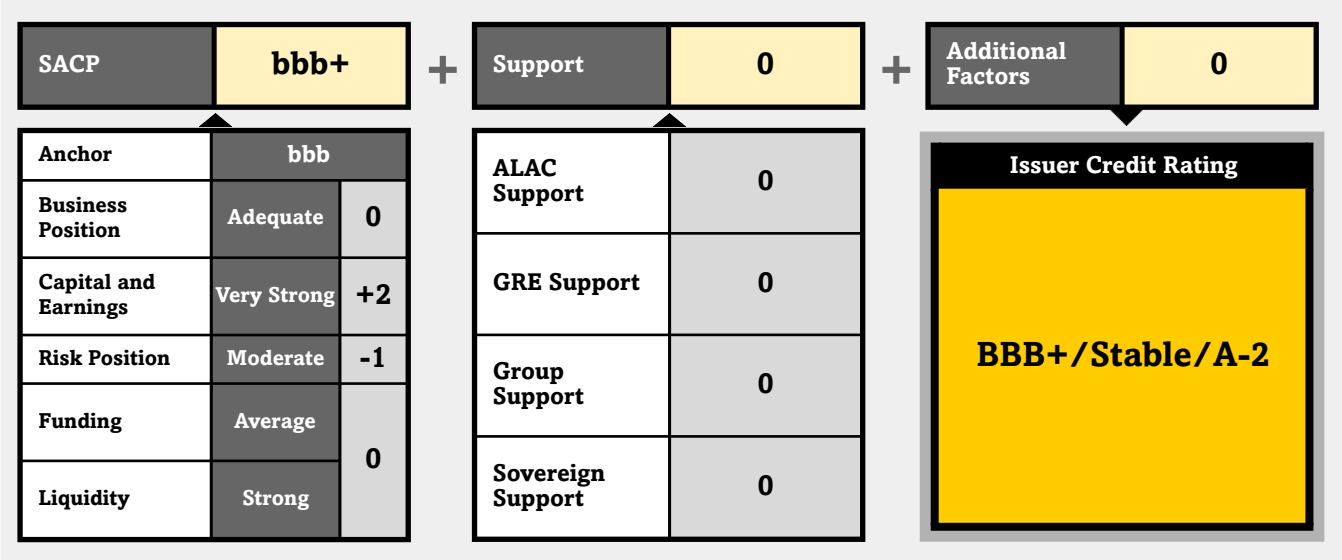
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Landsbankinn hf.



Major Rating Factors

Strengths:	Weaknesses
<ul style="list-style-type: none"> • Very high capital and 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 of the Icelandic banking sector.

Outlook

S&P Global Ratings' stable outlook on Icelandic Landsbankinn reflects its expectations that the bank's risk-adjusted capital (RAC) ratio will remain above 15% over the next two years, despite high dividend payments and share buy-back programs. We view the bank's asset quality as in line with the risks in the Icelandic market and with domestic peers'. The stable outlook further balances our view of strong economic development in Iceland against the relatively concentrated and volatile nature of the Icelandic economy and increasing economic imbalances.

We could lower the rating if Landsbankinn's RAC ratio declined more than expected, or if loan asset quality deteriorated materially, requiring significant unexpected additional provisioning. This could follow a quicker-than-expected sale to owners we view as more aggressive.

We do not currently expect to raise the rating as we see limited room for an improved view of the Icelandic banking market. In addition, we expect the bank's outstanding capital strength and leverage ratios to reduce materially in the coming years.

Rationale

Our rating on Landsbankinn reflects its leading market position in Iceland, comfortable capitalization level, and strong liquidity profile. At the same time, the rating also factors in the bank's geographic concentration in a small and volatile economy, material exposure to riskier small and midsize enterprise (SME) sector, and uncertainties around the bank's privatization process.

Anchor: 'bbb' for banks with an Icelandic focus

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 'bbb', based on an economic risk score of '4' 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 declines in the banks' nonperforming assets, low new loan losses, private sector credit below 140% of GDP in 2016, and the successful release of capital controls in 2017. In addition, we believe that economic resilience in Iceland is strengthening, as reflected by strong economic growth, vastly improved sovereign finances, and low unemployment. We anticipate that the country's prosperous but concentrated economy will achieve annual real GDP growth of about 4% over the next two years, supported by a continued increase in tourism. While this is positive for the overall economic growth, we see a risk for general overheating, decreased competitiveness in other export sectors, and growing imbalances, underscored by the over 20% annual house price increase at midyear 2017.

Several factors contribute to our view of industry risk. Since the financial crisis, Iceland has moved to a stronger regulatory system and an improved funding model based on domestic deposits and covered bonds, and high shares of equity capital, and complemented by foreign wholesale funding for the Icelandic banks. We expect returns will continue to be based on sound commercial practices. Substantial one-off items have inflated banks' profits over the past few years, but we expect the future impact will be contained to sales of equity positions as they are reduced further.

Table 1

Landsbankinn hf. Key Figures					
	--Year-ended Dec. 31--				
(Mil. ISK)	2017*	2016	2015	2014	2013
Adjusted assets	1,195,989	1,108,523	1,116,646	1,097,145	1,150,931
Customer loans (gross)	922,758	874,368	845,206	759,802	731,412
Adjusted common equity	227,952	235,591	234,019	225,891	220,877
Operating revenues	39,575	47,879	54,395	43,486	55,240
Noninterest expenses	17,686	23,514	23,732	24,088	27,251
Core earnings	15,998	19,163	26,788	14,683	12,775

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

Business position: Largest Icelandic bank with strong SME franchise

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. 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) 1.2 trillion (about €9.7 billion) at end-September 2017, 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, though we anticipate a recalibration of the capital base via the issuance of capital instruments to offset high dividend payments over the next two years. We take a positive view of management's proactive efforts to prepay the legacy 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 plans to reduce its stake in the bank to 34%-40% over time, but due to the off-cycle elections this past October 2016 and again in October 2017, the sales process has been held up, and we do not expect any material divestments over our two-year outlook horizon. We believe the government will withdraw its ownership from Landsbankinn in stages, and we assume that the government does not intend to hold a majority stake in the bank over the longer term.

Chart 1

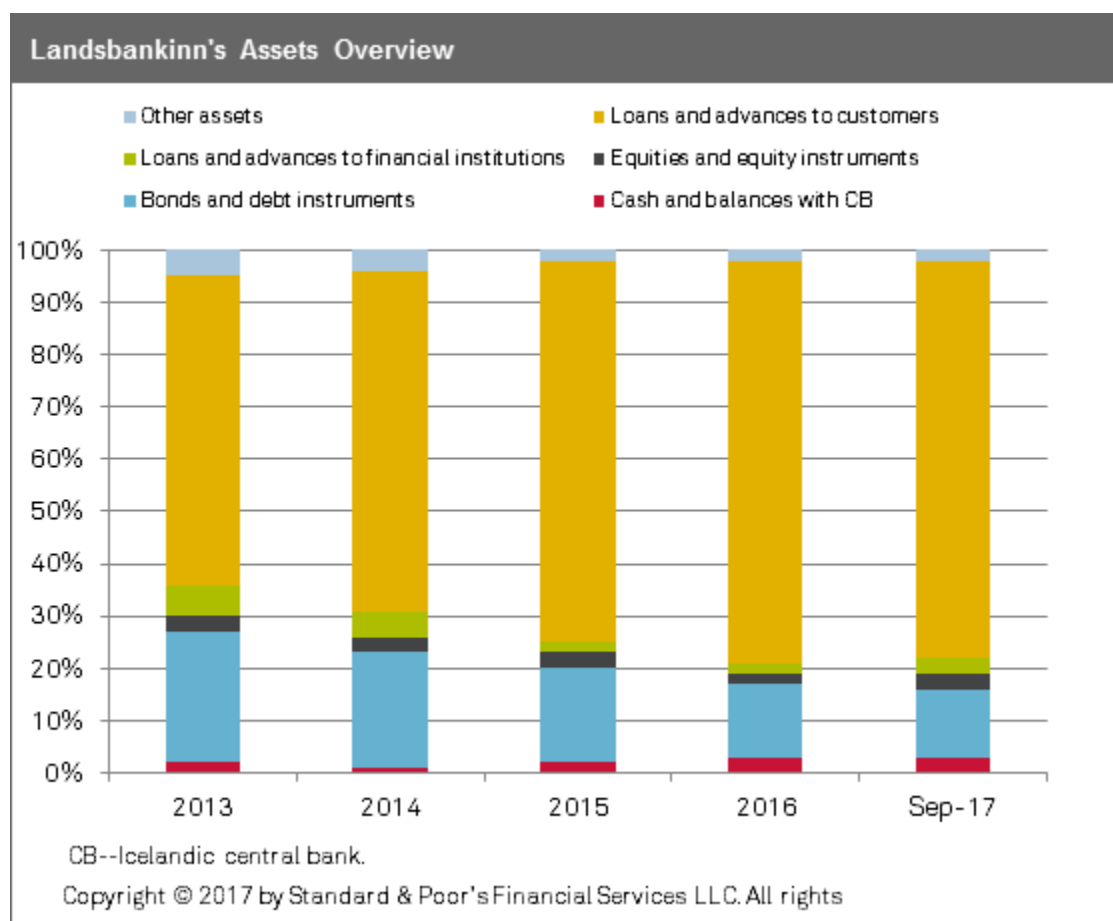


Table 2

Landsbankinn hf. Business Position

	--Year-ended Dec. 31--				
(%)	2017*	2016	2015	2014	2013
Loan market share in country of domicile	N/A	25.6	24.4	22.9	21.9
Deposit market share in country of domicile	N/A	34.5	31.1	31.7	25.9
Total revenues from business line (mil. ISK)	40,690	49,018	68,171	63,496	75,999
Commercial banking/total revenues from business line	32.1	31.2	21.2	25.3	18.2
Retail banking/total revenues from business line	35.3	38.2	27.4	28.4	24.9
Commercial & retail banking/total revenues from business line	67.4	69.4	48.6	53.8	43.2
Trading and sales income/total revenues from business line	8.1	17.5	8.1	6.6	11.2
Other revenues/total revenues from business line	24.6	13.1	43.3	39.6	45.6
Investment banking/total revenues from business line	8.1	17.5	8.1	6.6	11.2
Return on equity	9.1	6.5	14.2	12.1	12.3

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

Capital and earnings: Relatively high capital ratio while earnings stabilize at lower levels

Although the capitalization should gradually reduce, we consider it will remain relatively high and, as such, a positive rating factor. The RAC ratio as of end-June 2017 was 19.9% (pro forma our revised view of Iceland's economic risks), a slight increase from 19.3% at year-end 2016 with lower risk weights offsetting an extraordinary dividend payment. We anticipate a reduction of capital over 2019, at around 16.5%, on the back of sustained dividend (regular and extraordinary) payments and replacement of part of the equity base with debt.

Our capital forecasts are supported by the current state ownership of the bank and regulatory capital requirements. Specifically, we expect that the government will remain Landsbankinn's majority shareholder and keep a cautious stance on capital.

Moreover, the regulatory capital requirements in Iceland are high relative to other European countries, mostly due to the concentrated and volatile nature of the Icelandic economy. This led to total capital requirement of 21.2% at Sept. 30, 2017, for Landsbankinn. We note that Landsbankinn's 26.8% total capital ratio as of Sept. 30, 2017, remains well above the requirement and the common equity tier-1 (CET1) ratio stood at 26.3% at the same time. Furthermore, the bank has an outstanding leverage ratio compared with its Nordic peers, at 18.1% at end-September 2017.

Landsbankinn's profits have been volatile due to a large impact from revaluations of financial assets and legacy loans acquired at deep discounts, loan loss reversals, and litigation from legacy foreign currency (FX)-linked loans. We expect these impacts to be small going forward, and anticipate that core earnings to equity will stabilize around 7%-8% over our two-year forecast, with return on equity remaining at around 8%. We expect a stable net interest margin, given that competitive pressure on margins and a relative increase in mortgage lending would be partly offset by lower funding costs. The temporary bank tax levy used to fund debt relief for Icelandic residential borrowers has been extended and constitutes a charge of about 1.4% of equity per annum.

We expect Landsbankinn's earnings buffer, which measures the capacity for a bank's earnings to cover normalized losses, will remain adequate, between 150-175 basis points (bps).

We consider that Landsbankinn will continue to pay out most of its net profits as dividends, combined with extraordinary dividends in order to decrease the total capital base. Landsbankinn's equity at end-September 2017 declined 3% year to date, which is mostly due to the payment of dividends during the year. More specifically, in March 2017, a dividend of ISK13 billion was paid to the shareholders, followed by an extraordinary dividend of ISK11.8 billion paid at end-September 2017. This represent a total dividend yield of 9.9% for 2017, compared to 10.8% in 2016, mostly due to lower profits for the year.

Table 3

Landsbankinn hf. Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2017*	2016	2015	2014	2013
Criteria reflected in RAC ratios	N/A	2017	2010	2010	2010
Tier 1 capital ratio	26.3	29.7	30.3	29.5	27.1
S&P Global Ratings' RAC ratio before diversification	N/A	19.3	16.8	14.1	13.7
S&P Global Ratings' RAC ratio after diversification	N/A	13.3	13.1	11.1	11.1

Table 3

Landsbankinn hf. Capital And Earnings (cont.)					
	--Year-ended Dec. 31--				
(%)	2017*	2016	2015	2014	2013
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	68.4	72.4	59.4	64.6	62.1
Fee income/operating revenues	16.7	16.3	12.6	13.4	9.6
Market-sensitive income/operating revenues	11.7	3.3	21.0	12.6	20.4
Noninterest expenses/operating revenues	44.7	49.1	43.6	55.4	49.3
Preprovision operating income/average assets	2.5	2.2	2.8	1.7	2.5
Core earnings/average managed assets	1.8	1.7	2.4	1.3	1.1

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

Table 4

Landsbankinn hf. Risk-Adjusted Capital Framework Data					
(Mil. ISK)	Exposure*	Basel III RWA	Average Basel III RW (%)	S&P Global Ratings' RWA	Average S&P Global Ratings' RW (%)
Credit risk					
Government and central banks	171,748	2,238	1	10,787	6
Institutions and CCPs	53,996	12,975	24	11,274	21
Corporate	525,484	487,725	93	495,410	94
Retail	401,127	194,038	48	223,788	56
Of which mortgage	257,063	106,125	41	93,509	36
Securitization§	0	0	0	0	0
Other assets†	36,297	42,640	117	47,231	130
Total credit risk	1,188,652	739,615	62	788,490	66
Credit valuation adjustment					
Total credit valuation adjustment	--	675	--	0	--
Market risk					
Equity in the banking book	18,948	18,948	100	212,601	1,122
Trading book market risk	--	17,250	--	25,875	--
Total market risk	--	36,198	--	238,476	--
Operational risk					
Total operational risk	--	91,813	--	99,357	--
		Basel III RWA		S&P Global RWA	% of S&P Global RWA
Diversification adjustments					
RWA before diversification		868,300		1,126,323	100
Total Diversification/Concentration Adjustments		--		491,605	44
RWA after diversification		868,300		1,617,928	144

Table 4

Landsbankinn hf. Risk-Adjusted Capital Framework Data (cont.)				
	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global Ratings' RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	236,016	27.2	223,859	19.9
Capital ratio after adjustments†	236,016	27.2	223,859	13.8

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡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, 2017, S&P Global.

Risk position: Improving asset quality and economic environment, while concentration risks remain

Our view of Landsbankinn's risk position mainly reflects its geographic concentration in a relatively volatile economy. Given Landsbankinn's large market shares in retail and SME lending, we consider the bank's risk profile to remain highly correlated to the domestic economy. For example, we note that the loan-to-value (LTV) could increase in case of high inflation, due to the high share of consumer price index-linked loans in the Icelandic market, which stood at almost 40% of customer loans at end-September 2017 (see chart 2).

Landsbankinn's asset quality has improved as the Icelandic economy has recovered from the crisis, and the bank reported material net impairment reversal since 2014. The reversals are connected to over-provisioning for legacy assets, and we expect only minor repercussions going forward. We expect loan impairments will remain low due to increased efforts to improve credit quality. As such, we anticipate normalized levels of new credit losses at about 30 bps over the coming two years, though one-off recoveries could create volatility.

The sustained increase in customer loans over the last years (+7.4% year to date as of September 2017) has not come at expense of credit quality. On the contrary, gross nonperforming assets (NPAs) were 3.99% of customer loans and repossessed assets as of September 30, 2017, down from 5.04% at year-end 2016 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 with Islandsbanki and Arion. Indeed, Landsbankinn's loans classified as more than 90 days past due, stood at only 1% of the lending portfolio as of September 2017, compared to 1.1% for both Arion Bank and Islandsbanki.

At the same time, we will continue monitoring the bank's 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 expanding as the demand for new real estate is high, driven by a young population and booming tourism. We note that Landsbankinn's lending to construction companies has increased slightly in the last year, to about 9% of total loans. The weighted average loan-to-value ratio as of September 2017 stood at 60.1%, compared to 62.3% at end-2016 and 63.5% at end-2015.

Chart 2

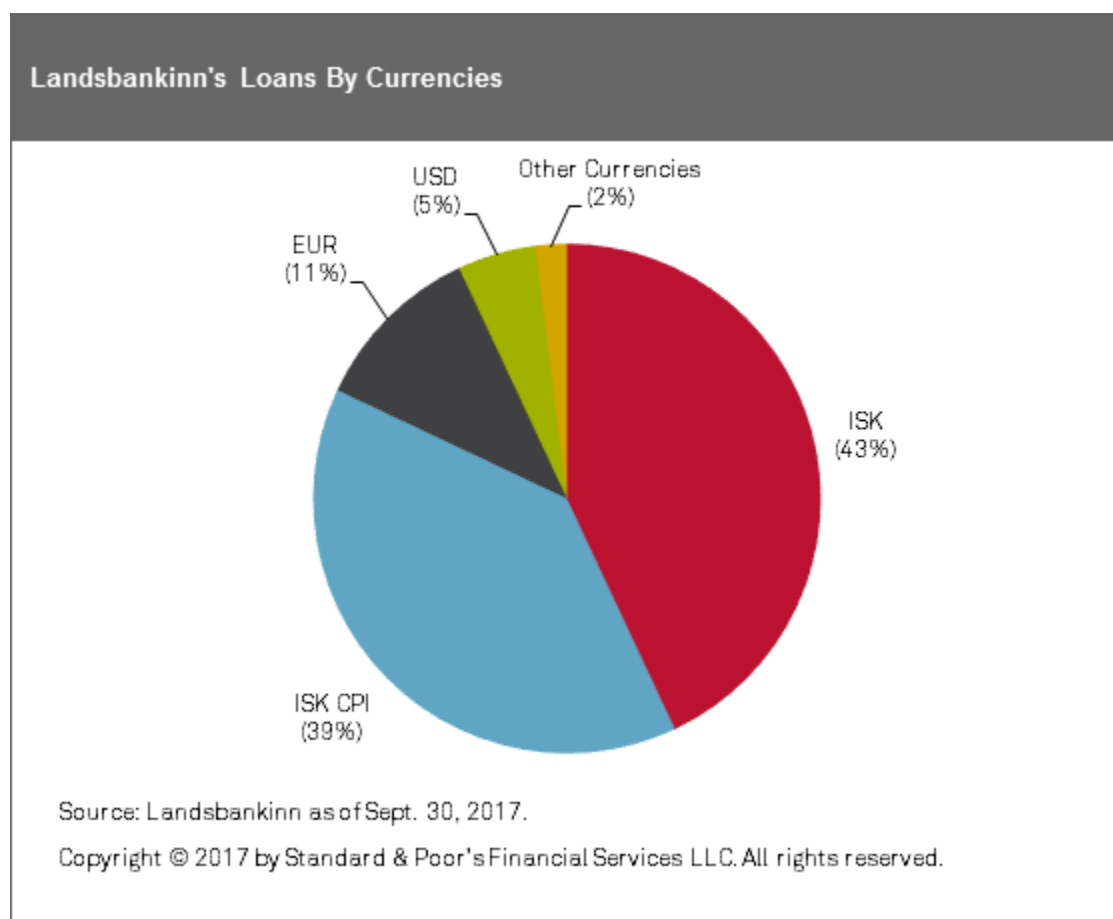


Table 5

Landsbankinn hf. Risk Position

(%)	--Year-ended Dec. 31--				
	2017*	2016	2015	2014	2013
Growth in customer loans	7.4	3.5	11.2	3.9	3.0
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	45.6	29.0	27.0	22.6
Total managed assets/adjusted common equity (x)	5.3	4.7	4.8	4.9	5.2
New loan loss provisions/average customer loans	(0.1)	(0.6)	(0.6)	(0.0)	1.1
Net charge-offs/average customer loans	0.5	0.9	0.7	1.6	0.1
Gross nonperforming assets/customer loans + other real estate owned	4.0	5.0	8.3	12.5	18.5
Loan loss reserves/gross nonperforming assets	45.4	47.1	47.1	42.5	36.4

*Data as of Sept. 30. N/A--Not applicable. RWA--Risk-weighted assets.

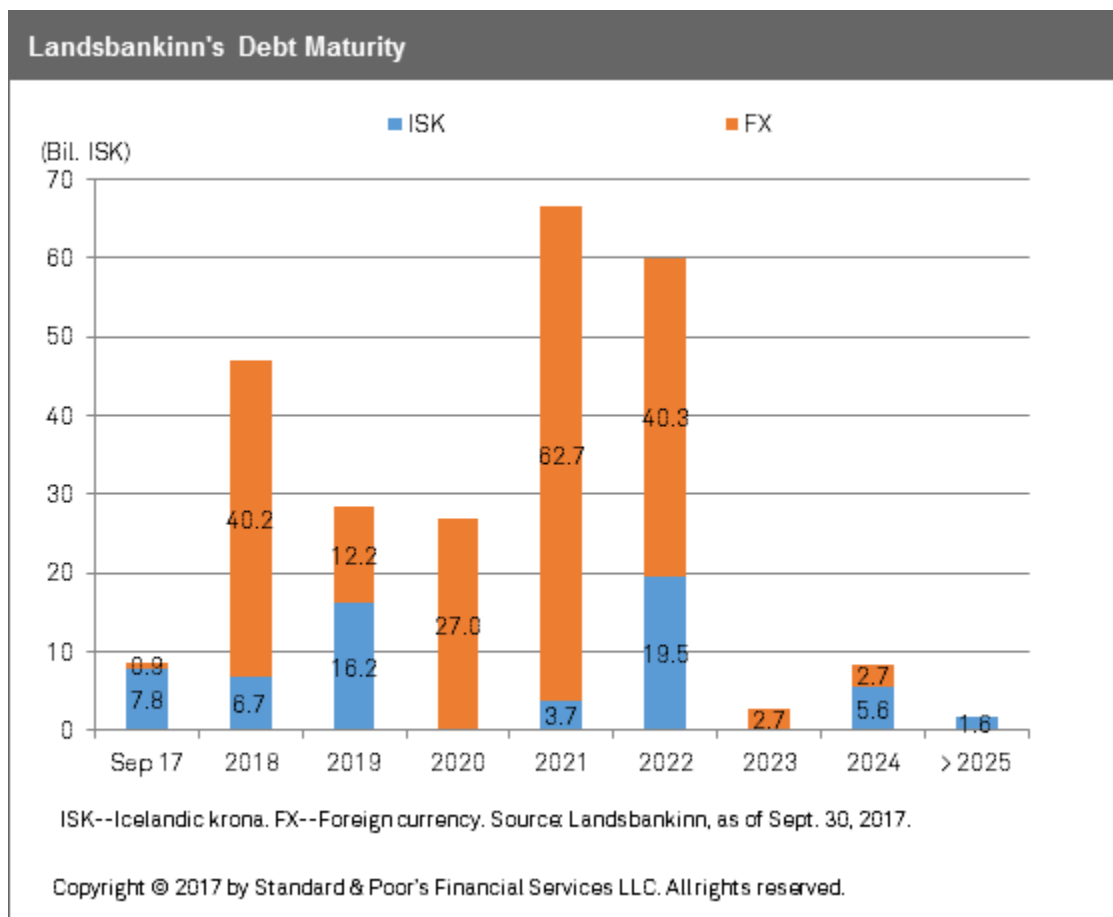
Funding and liquidity: Prudent liquidity management and solid funding metrics

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 the uncertainty about the long-term funding structure of Icelandic banks. With the final release of capital controls earlier in 2017 and a rapid, expected decrease of capital, the reliance on

wholesale funding could increase further. Therefore, funding and liquidity combined remain a neutral factor for the ratings despite slightly stronger metric than international peers, supported by strict regulation. Furthermore, Icelandic banks' access to wholesale markets, domestic as well as international, is likely to be confidence sensitive until the new banks have established a better track record than the old bank estates in difficult market conditions. These factors weigh on our assessment of Landsbankinn's funding profile, constraining ratings upside from funding and liquidity. The bank is dependent on customer deposits as well as wholesale funding for its funding needs. Customer deposits formed 71.10% of the funding base at September 30, 2017, and the rest is wholesale funding, mostly consisting of senior unsecured bonds and covered bonds. We expect that the deposits may decline as depositors can invest abroad to a larger extent since the final release of capital controls. However, the concerns that the release would lead to rapid outflows did not materialize.

Earlier in 2017, Landsbankinn prepaid the remainder of the bonds held by the former estate Landsbanki Islands, using the proceeds from senior unsecured bonds issued in the EU and Scandinavia, at significantly better terms than the old bonds. Moreover, last month, the bank managed to buy back half of its €300 million senior unsecured bond, 3% coupon, maturing in 2018 (see chart 3). This was then refinanced with a €300 million senior unsecured bond, maturing in 5.5 years, at much lower rate (85 basis points over mid-swap).

Chart 3



We do not expect the foreign funding to increase significantly more, since FX-denominated loans are only granted to customers with cash flow in the same currency and the Icelandic krona swap market is limited. Landsbankinn's stable funding ratio was at 116.4% at September 2017, compared to 110.7% at the end of 2016, and we believe it to remain solid in the coming years.

We consider liquidity as strong, as broad liquid assets covered short term wholesale funding by 6.8x at September 2017. The ratio is strong but volatile and was down at 2.9x at year-end 2016, and we expect it to remain high. The total liquidity coverage ratio continuously increased over the last years, and it stood at 158% at end-September 2017, compared to 128% at end-2016.

Table 6

Landsbankinn hf. Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2017*	2016	2015	2014	2013
Core deposits/funding base	68.7	70.7	67.5	67.5	52.5
Customer loans (net)/customer deposits	141.8	144.7	145.2	130.3	149.0
Long-term funding ratio	97.1	93.7	93.5	93.9	82.4
Stable funding ratio	116.4	110.7	115.7	121.9	115.1
Short-term wholesale funding/funding base	3.6	8.1	8.6	7.9	22.4
Broad liquid assets/short-term wholesale funding (x)	6.8	2.9	3.4	4.4	1.8
Net broad liquid assets/short-term customer deposits	30.5	23.0	32.6	40.8	38.1
Short-term wholesale funding/total wholesale funding	11.6	27.7	26.3	24.3	47.2
Narrow liquid assets/3-month wholesale funding (x)	8.5	4.2	4.8	4.7	1.9

*Data as of Sept. 30.

External support: Government support for Icelandic banks is uncertain

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 34%-40% 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. 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.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology

And Assumptions, Jan. 29, 2015

- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Positive Rating Actions Taken On Four Icelandic Lenders On Improving Economic Conditions, Oct. 25, 2017

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 15, 2017)

Landsbankinn hf.

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

Counterparty Credit Ratings History

25-Oct-2017	BBB+/Stable/A-2
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

Sovereign Rating

Iceland (Republic of)	A/Stable/A-1
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*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.

Additional Contact:

Financial Institutions Ratings Europe; FIG_Europe@spglobal.com

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