

Credit Opinion: PrivatBank AS

PrivatBank AS

Riga, Latvia

Ratings

Category	Moody's Rating
Outlook	Negative
Bank Deposits	B2/NP
Bank Financial Strength	E+

Contacts

Analyst	Phone
Kimmo Rama/London	44.20.7772.5454
Eeva Antila/London	
Reynold R. Leegerstee/London	
Fimi Gostanian/Limassol	357.25.586.586

Key Indicators

PrivatBank AS

	[1]2009	[2]2008	2007	2006	2005	[3]Avg.
Total assets (LVL billion)	0.17	0.18	0.14	0.10	0.07	[4]40.06
Total assets (EUR billion)	0.25	0.26	0.19	0.15	0.10	--
Total capital (LVL billion)	0.02	0.02	0.02	0.01	0.01	[4]28.30
Return on average assets	0.62	0.02	1.00	1.21	1.42	0.96
Recurring earnings power [5]	0.99	1.42	1.50	1.93	1.73	1.60
Net interest margin	3.01	3.70	4.48	4.34	3.08	3.45
Cost/income ratio (%)	81.39	78.50	78.29	73.53	72.36	75.04
Problem loans % gross loans	0.00	16.82	4.59	1.45	--	7.62
Tier 1 ratio (%)	0.00	10.79	10.20	8.69	13.82	13.59

[1] As of March 31. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate. [5] Preprovision income % average assets.

Opinion

SUMMARY RATING RATIONALE

Moody's has assigned a bank financial strength rating (BFSR) of E+ to PrivatBank AS (previously Paritate Bank), which translates into a Baseline Credit Assessment (BCA) of B3. The bank's ratings are underpinned by the bank's retail focus and relatively well-diversified revenue mix. The ratings are constrained by the bank's small business franchise (a market share of less than 1% by total assets), high exposure to non-resident deposits, weakened financial performance and challenges arising from the deteriorating credit environment in Latvia. Moody's also notes corporate governance issues and the competitive challenges facing the bank.

PrivatBank's long-term global local currency (GLC) deposit rating is B2, reflecting Moody's assessment of a moderate probability of parental support from Ukraine's Privatbank Commercial Bank CJSC (B3/NP/D-, negative outlook), which currently holds 95% of the bank's capital. With total assets of US\$14.5 billion (at end-2008) PrivatBank (Ukraine) is the largest bank in Ukraine. Moody's believes that there would be no systemic support for PrivatBank in the event of a stress situation, taking into consideration the incidence of historical bank support in Latvia and in accordance with our low system support guidelines for the country. However, given our assessment of parental support there is a one-notch uplift for PrivatBank's GLC deposit rating from its B3 BCA.

On 12 December 2008, Moody's downgraded the long-term foreign and local currency deposit ratings of PrivatBank to B2 from B1. The outlook on the long-term foreign and local currency deposit ratings and the BFSR is negative.

Credit Strengths

- High proportion of retail business
- Relatively well-diversified revenue mix

Credit Challenges

- Preserving asset quality in the current economic slowdown
- Corporate governance challenges in view of ownership concentration
- High proportion of non-resident deposits
- Weak cost efficiency

Rating Outlook

The outlook on the long-term foreign and local currency deposit ratings and the BFSR is negative. This reflects Moody's concerns that the bank's credit quality may continue to deteriorate further, especially considering that its operations continue to be severely adversely affected by the ongoing recession in Latvia.

What Could Change the Rating - Up

Given that the BFSR and the long-term deposit ratings currently have a negative outlook, an upgrade of the ratings is unlikely.

What Could Change the Rating - Down

The key considerations at the moment are related to the asset quality of PrivatBank's loan portfolio, the bank's capitalisation and its ability to replenish capital in a stress scenario. The BFSR could also be negatively affected by further deterioration in profitability and/or liquidity.

A downgrade of the bank's GLC deposit rating could occur if (1) PrivatBank's BFSR were downgraded, and/or (2) the parental support from the Ukrainian parent bank were to decrease.

Recent Results and Company Events

PrivatBank's profitability weakened in 2008 when its net income decreased by 96% compared with 2007, mainly as a result of increased loan loss provisions. Loan loss provisions accounted for a high 97% of the bank's pre-tax, pre-provision income. Positively, net interest income and net fee and commission income remained solid, growing by 18% and 16%, respectively, year-on-year. Overall, pre-tax, pre-provision income increased by nearly 30% to LVL2.2 million in 2008; in terms of recurring earnings power, the pre-provision profits-to-average assets ratio was 1.42% (2007: 1.5%). PrivatBank continues to report weak efficiency. The bank's cost-to-income ratio stood at 78% in 2008, unchanged from the previous year.

The bank's total customer deposits increased 55% and accounted for 81% of total funding at end-2008 (end-2007: 75%). The bank's total capital adequacy ratio stood at 10.8% at end-2008 (end-2007: 14.3%). Due to the deteriorating economic environment weakening asset quality has become visible in the bank's asset quality figures. PrivatBank's problem loans (i.e. individually impaired and over 90 days past due, but not impaired loans) accounted for 16.8% of gross loans at end-2008, significantly up from 4.6% at end-2007. Loan growth was 25% in 2008, down from 60% in 2007.

DETAILED RATING CONSIDERATIONS

Detailed considerations for PrivatBank's currently assigned ratings are as follows:

Bank Financial Strength Rating

Moody's assigns an E+ BFSR to PrivatBank, which reflects the bank's retail focus and relatively well-diversified revenue mix. The ratings are constrained by the bank's small business franchise (a market share of less than 1%), high exposure to non-resident deposits, weakened financial performance and challenges arising from the

deteriorating credit environment in Latvia. Moody's also notes corporate governance issues and the competitive challenges facing the bank

As a point of reference, the assigned rating is two notches lower than the adjusted D outcome of Moody's bank financial strength scorecard. Moody's believes the E+ BFSR to be a more accurate representation of the bank's financial strength given the constraining factors described above that are not fully captured by the scorecard outcome.

Qualitative Factors (70%)

Factor 1: Franchise Value

Trend: Neutral

PrivatBank is primarily engaged in providing banking services to local and non-resident private individuals (including high-net-worth individuals as well as domestic and foreign corporate customers). At end-March 2008, the bank ranked 16th among 27 Latvian banks. PrivatBank's franchise score reflects the bank's market share by total assets of less than 1%.

In general, lending activities are largely conducted with domestic customers and deposit-taking activities with non-resident clients. The bank is also becoming increasingly involved in retail mortgage lending. Residential mortgage loans accounted for approximately 55% of loan volume as at end-2008. The bank's primary focus is on Latvian individuals and SMEs, and also has a role in money transfer services between the former Soviet Union countries and the EU. In addition, the bank is seeking to develop its branch network in EU countries to serve Ukrainian expatriates. In serving high-net-worth individuals, PrivatBank takes advantage of its parent bank's experience.

Originally established in 1992, PrivatBank was previously known as Paritate Banka. After Ukraine's PrivatBank acquired a majority stake in the bank, Paritate Banka changed its name to PrivatBank in August 2007. PrivatBank is part of the Ukrainian PrivatBank Group, which consists of four entities: PrivatBank (Latvia), Commercial Bank PrivatBank International Banking Unit (Cyprus), MoscomPrivat Bank (Moscow) and Tao Bank (Tbilisi). It also has three subsidiaries of its own: DigiPro (POS terminals), Privat Consulting (tourism services) and Privat Lizings (car leasing services).

The bank expanded its customer offices in Latvia from 5 in 2004 to 22 in 2008, of which 12 are located outside Riga. Also, it opened a branch in Portugal in 2007 and plans to open branches in Italy, Spain and in other EU countries with significant Ukrainian populations.

In light of the above factors, the overall score for PrivatBank Bank's franchise value is E+.

Factor 2: Risk Positioning

Trend: Neutral

Our assessment of PrivatBank's risk positioning is influenced by weaknesses in terms of corporate governance. Moody's notes that the bank is owned by Ukraine's Privatbank, which has a 95.07% stake in the bank. The parent bank is itself primarily held by three individual owners. Moody's believes that these shareholders have significant decision-making authority with regard to the business operations of PrivatBank, although the parent bank and PrivatBank have different board members. PrivatBank is closely connected to its parent bank as it has outsourced its IT systems and uses similar risk management systems.

Potential risks mainly stem from the bank's rapidly growing loan portfolio (25% in 2008, 60% in 2007 and 90% in 2006). Residential mortgage loans account for over half of the portfolio (54%) while the share of unsecured consumer loans was below 4% at end-2008. Around 97% of total loans are to residents of Latvia.

The bank's borrower concentration is relatively high. The 20 top exposures amounted to less than 80% of the bank's Tier 1, but in relation to pre-provision income the concentration ratio is very high. With over 64% of total loans to private individuals at year-end 2008, industry concentration is not a cause for concern. Of the total loan portfolio, around 9% was to the real estate sector at year-end 2008. These loans are typically collateralised and consist of loans to SMEs involved in building and selling family houses or flats. Similar to other Latvian banks the bank's loan portfolio is predominantly in foreign currencies. At end-2008, foreign currency denominated loans accounted for 90% of total customer loans.

Over the past two years, customer deposits have accounted for an average of 80% of the bank's funding. We note the bank's deposit base exhibits some concentration risk, although this risk has decreased from the previous years. The 20 largest depositors accounted for less than 10% of aggregate deposits at end-2008. The bank's deposit base is mainly non-resident. At end-2008, non-resident deposits accounted for 66% of total customer deposits. Of the non-resident customer deposits, some 34% were residents of non-OECD countries. The maturity structure of deposits has improved, 68% of deposits were demand deposits at end-2008, up from 46% in 2007.

PrivatBank exhibits low market risk appetite. The bank has not been directly affected by the financial market turmoil as it does not have a securities portfolio and trading activities are connected with foreign currency exchange operations conducted on behalf of clients only. The bank reviews its adherence to open currency regulatory limits (the total open currency position cannot exceed 20% of equity) on a daily basis. The bank does not carry out proprietary trading activities and it implements a VaR model for measuring the currency risk.

The bank exhibits modest earnings stability. Geographically, earnings are predominantly from Latvia. The bank considers other smaller Latvian banks as its core competitors. The level of information in the annual reports provides good insight into its business and financial performance.

In light of these factors, the overall score for PrivatBank's risk positioning is D.

Factor 3: Regulatory Environment

For a discussion of the regulatory environment, please see Moody's latest Banking System Outlook on Latvia, published in December 2008.

Factor 4: Operating Environment

Trend: Neutral

The credit standing of banks operating in Latvia and the Baltic region as a whole remains constrained by the strained and relatively immature operating environment. As a major importer of foreign capital, Latvia's economy has suffered significantly during the global liquidity crisis. The spectrum of factors that previously combined to drive rapid economic and financial growth is now operating in reverse. GDP is forecast to contract by more than 10% in 2009, and the recession could spread into 2010.

The Latvian government introduced an economic stabilisation plan in cooperation with the IMF and EU in December 2008. The plan focuses on maintaining the currency peg at the current exchange rate, containing the fiscal deficit and supporting the banking system. The plan is being accompanied by EUR7.5 billion in extraordinary financing from the IMF, EU, Nordic governments and various other European governments and international financial institutions, reflecting Latvia's high level of private sector external financing requirements over the next two years.

The size of the financing package demonstrates the commitment of the IMF and - more importantly - the EU to Latvia's currency peg. With such a high degree of international support, the current exchange rate should prevail until Latvia is able to adopt the euro, possibly in 2012, although there is material probability of a devaluation. Whether there is a devaluation or not, the economic recession will be especially severe as imbalances correct and the private sector deleverages. Rising unemployment, falling asset prices and significant corporate stress will probably lead to widespread insolvencies.

The score for Latvia's operating environment is D.

Quantitative Factors (30%)

Factor 5: Profitability

Trend: Weakening

PrivatBank's profitability weakened in 2008, with the bank's net income decreasing by 96% compared with 2007, mainly as a result of increased loan loss provisions. Loan loss provisions accounted for a high 97% of the bank's pre-tax, pre-provision income. Positively, net interest income and net fee and commission income remained solid, growing by 18% and 16%, respectively, year-on-year. Overall, pre-tax, pre-provision income increased by nearly 30% to LVL2.2 million in 2008; in terms of recurring earnings power, the pre-provision profit-to-average assets ratio was 1.42% (2007: 1.5%).

Net interest income is the major driver of the bank's operating income, representing 51% of operating income in 2008 (2007: 55%). Positively, Moody's notes that fee and commission income continues to comprise a significant and stable portion of approximately 23% of the total operating income.

The bank continues to benefit from relatively strong margins, but remains susceptible to margin attrition due to higher funding costs. In 2008, the bank's net interest margin was 3.7%, down from 4.5% in 2007.

The profitability ratios on the scorecard, which are expressed in relation to average risk-weighted assets, have been computed using Basel II risk-weighted assets. Therefore, the scorecard reflects only 2008 profitability. The score for PrivatBank's profitability is D. We add a weakening trend given the weak economic outlook for Latvia, which is likely to increase loan loss provisioning needs and therefore affect profitability.

Factor 6: Liquidity

Trend: Neutral

Like many other smaller Latvian banks, PrivatBank displays a substantial reliance on non-resident deposit-based funding. Due to sizeable amount of deposits the bank remains relatively underleveraged. At end-2008, the bank's deposits-to-loans ratio stood at 117%.

In 2008, the bank's total customer deposits increased by 55% and accounted for 81% of total funding (2007: 75%). Its deposit funding profile was characterised by at end-2008: (i) improved maturities (demand deposits accounted for 68% of deposits, up from 46% at end-2007), (ii) the predominance of non-resident depositors (66%) and (iii) the preponderance of foreign currency deposits (85%).

Given the bank's exposure to non-resident deposits, in Moody's view, the bank displays a greater vulnerability to the threat of external shocks than banks that have a more substantial domestic retail deposit base. Positively, over the past two years, the bank has diversified its funding by issuing mortgage bonds of LVL14.8 million or around 12% of total funding as of end-2008.

The overall score for liquidity is C-, but Moody's believes that this does not capture the vulnerability of the more confidence-sensitive non-resident deposit base to withdrawals. After adjusting for non-resident deposits and potentially less liquid assets in the securities portfolio, the adjusted score for liquidity becomes D.

Factor 7: Capital Adequacy

Trend: Weakening

In 2008, the bank reported adequate but weakened capitalisation. The bank's total capital adequacy ratio stood at 10.8% at the end of the year, down from 14.3% at end-2007 (Basel II). In March 2009, the bank received a capital injection in the form of a subordinated loan of US\$13 million. As a result, the total capital ratio was 14.8% at the end of March 2009.

The score for capital adequacy is A. However, we adjust the score downward to a B score, attaching to it a weakening trend to capture the bank's diminished internal capital generation capacity. The bank has set a target to maintain its capital adequacy at 9.0%-9.5%.

Factor 8: Efficiency

Trend: Weakening

PrivatBank continues to report weak efficiency. The bank's cost-to-income ratio stood at 78% in 2008, unchanged from the previous year. The bank's operating expenses-to-average assets ratio was 5.2% in 2008, down from 5.4% in 2007. Efficiency improvements as well as the maintenance of credit quality will be instrumental in enhancing the bank's financial flexibility going forward. However, the bank's domestic and international expansion continues to put pressure on its future efficiency improvements, which explains the weakening trend.

The bank's score for efficiency is D. The negative trend reflects future cost pressure. PrivatBank plans to further develop its domestic branch network and is also targeting EU-wide opportunities in terms of servicing the Ukrainian clients of its parent bank. The bank has already opened a branch in Portugal and a registered branch in Italy. In addition, international branch network expansion into the following countries has been planned: Spain, Greece and Germany.

Factor 9: Asset Quality

Trend: Weakening

Due to the deteriorating economic environment in Latvia, weakening asset quality has become visible in the bank's asset quality figures. PrivatBank's problem loans (i.e. individually impaired and over 90 days past due, but not impaired loans) accounted for 16.8% of gross loans at end-2008, significantly up from 4.6% at end-2007. Loan loss reserves provided a 14% coverage of problem loans at end-2008 (end-2007: 21%), which in Moody's opinion is low. Moody's estimates that should the bank have provided a 50% loan loss reserve coverage against problem loans in 2008, the bank would have needed to increase its loan loss provisions by more than four fold. As a result, the bank would have reported a pre-tax loss of LVL 6.9 million (vs. actual reported pre-tax profit of LVL 0.06 million). The bank has not disclosed its asset quality data for Q1 2009.

The bank's loan portfolio has been growing rapidly. Although its loan growth slowed down to 25% in 2008 (2007: 60%), this was still above the Latvian banking system average of 11%.

Although the bank's customer loan portfolio is dominated by residential mortgages (around 55% of total loans at end-2008), additional concerns relate to industry concentrations within its corporate loan portfolio. Moody's notes that PrivatBank's exposure to the real estate and construction sector accounted for a relatively high 35% of total corporate lending at end-2008. However, it should be noted that the major part of the bank's problem loans stemmed from its retail loan portfolio (around 76% of all past due loans). The bank's exposure to unsecured consumer lending accounted for a relatively low 3.9% of total lending at end-2008.

Due to the bank's unseasoned loan book and the weak economic outlook for the Latvian economy, we expect some further weakening in asset quality going forward. Therefore, we have adjusted the score for asset quality to E from D.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's has assigned a GLC deposit rating of B2 to PrivatBank. The rating is supported by the bank's BCA of B1, and by the Ba3 BCA ratings of its underlying support provider - Ukraine's Privatbank Commercial Bank CJSC. In view of PrivatBank's marginal market share, the probability of systemic support in the event of a stress situation is viewed as "none" in accordance with the low system support guideline for Latvia.

Under Moody's Joint Default Analysis (JDA) methodology, these considerations result in a one-notch uplift in the GLC deposit rating to B2 from the bank's BCA of B3.

Foreign Currency Deposit Rating

Moody's has assigned a B2 foreign currency deposit rating to PrivatBank.

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. BFSRs 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 BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs 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.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR 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, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which 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 external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National scale ratings

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

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 ratings

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

PrivatBank AS

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (70%)						D	
Factor: Franchise Value						E+	Neutral
Market Share and Sustainability					x		
Geographical Diversification					x		
Earnings Stability				x			
Earnings Diversification [2]							
Factor: Risk Positioning						D	Neutral
Corporate Governance [2]					x		
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management				x			
- Risk Management					x		
- Controls			x				
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness				x			
- Quality of Financial Information				x			
Credit Risk Concentration	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management					x		
Market Risk Appetite				x			
Factor: Operating Environment						D	Neutral
Economic Stability				x			
Integrity and Corruption				x			
Legal System				x			

Financial Factors (30%)						C-	
Factor: Profitability						D	Weakening
PPP % Avg RWA - Basel II			1.62%				
Net Income % Avg RWA - Basel II					0.02%		
Factor: Liquidity						C-	Neutral
(Mkt funds-Liquid Assets) % Total Assets	-15.05%						
Liquidity Management					x		
Factor: Capital Adequacy						A	Weakening
Tier 1 ratio (%) - Basel II	10.79%						
Tangible Common Equity / RWA - Basel II	10.70%						
Factor: Efficiency						D	Weakening
Cost/income ratio				76.77%			
Factor: Asset Quality						D	Weakening
Problem Loans % Gross Loans				7.62%			
Problem Loans % (Equity + LLR)				49.91%			
Lowest Combined Score (9%)						D	
Economic Insolvency Override						Neutral	
Aggregate Score						D	
Assigned BFSR						E+	

[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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