

Why Basel III And Solvency II Will Hurt Corporate Borrowing In Europe More Than In The U.S.

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Why Basel III And Solvency II Will Hurt Corporate Borrowing In Europe More Than In The U.S.

The introduction of stricter regulatory frameworks for banks and insurers is likely to result, at best, in a repricing and, at worst, in a rationing of credit for corporates globally, in Standard & Poor's Ratings Services view. We believe that European corporates will feel the effect more harshly than their U.S. counterparts because they typically rely more heavily on banks for funding relative to capital market sources. The details still need to be ironed out on the Basel III global regulatory standard on bank capital adequacy and liquidity and on Solvency II, which codifies and harmonizes EU insurance regulation. Nevertheless, we believe these new regulations could bring about a substantial change in behavior by lenders and borrowers, and lead to profound changes in the capital markets.

Based on our simulations and certain assumptions, we calculate that the additional bank borrowing costs in the eurozone for corporates would be very large and range between €30 billion and €50 billion per year once the regulations are fully implemented by 2018. In contrast, we believe the impact would be significantly smaller for those borrowing from U.S. banks, ranging from \$9 billion to \$14 billion. This represents an increase of between 10% and 20% over current interest costs for corporate borrowers for Europe and the U.S., depending on banks' return on equity targets of 8% to 15%. We also anticipate that European corporates will increasingly turn to the capital markets as bank financing becomes pricier and the terms and conditions more restrictive as a result of the new regulations.

Nevertheless, although we conclude that borrowing costs are likely to increase significantly, and that there is a danger of credit rationing for corporates over the next few years as a result of the introduction of tighter regulatory requirements for both banks and insurers, this is not to say that we are advocating a liberalization of the regimes. We believe the regulatory changes will likely enhance the stability of the global financial markets, and we are supportive of a tightening of the regulatory environment for financial institutions.

Overview

- The Basel III and Solvency II proposals aim to enhance regulation of the banking and insurance sectors, respectively, starting in 2013.
- The combined impact for corporates could be higher funding costs, lower availability of longer term credit, and a lower equity investor base.
- We expect the impact to be greater in Europe because corporates typically rely much more on banks for funding than their U.S. counterparts.
- Among these corporates, the privately held, highly leveraged entities with a narrow business scope are likely to be affected the most, in our view.
- Based on certain assumptions and all other things remaining equal, we believe funding costs could increase in aggregate by between €30 billion and €50 billion for eurozone corporate borrowers and by between only \$9 billion and \$14 billion for U.S. corporate borrowers.
- This represents an increase of between 10% and 20% over current interest costs for corporate borrowers for Europe and the U.S., depending on banks' return on equity targets of 8% to 15%.

The Main Milestones Of The Regulatory Changes

Although the two regulatory frameworks Basel III and Solvency II were developed separately, the former by the Basel Committee on Banking Supervision and the latter by the EU, the financial community often refers to them in tandem. This is because, in combination, we expect the various changes to transform behavior on the capital markets as various aspects of them are implemented over the period 2013-2018. Although the timing of their implementation could be deferred or amended, the broad frameworks of the two regulatory regimes appear unlikely to change. We provide a summary of the key milestones below (see table 1). For an outline of the key points of the regulations see "Appendix: Basel III and Solvency II: A Primer", at the end of this article.

Table 1

Key Implementation Milestones Of Basel III And Solvency II For Corporate Borrowers		
2013	2015	2018
Basel III		
The cost of over-the-counter derivatives will rise significantly for end-users because of a steep increase in regulatory capital requirements for banks related to these transactions.	The introduction of the liquidity coverage ratio assumes that liquidity facilities (use without conditions) be 100% drawn, versus 10% drawn within one month for credit facilities with a dedicated use.	The introduction of the net stable funding ratio will require banks to provide 50% stable funding requirements for loans below one year, 100% for loans above one year. Also, corporate bonds rated 'AA-' and above need only 20% stable funding, corporate bonds rated between 'A' and 'AA-' 50%, and below 'A' 100%.
A sharp increase in market risk requirements for proprietary trading will increase the incentive for banks to lend to corporates.	Deposits of small and midsize enterprises (SMEs) will be assumed to be as stable as retail deposits. The regulation assumes an outflow of 5% / 10% on SME deposits over a one-month horizon compared with an outflow of 75% for large corporates.	
Solvency II		
Until 2013 (the earliest possible implementation date) there are no regulatory capital requirements for asset risk	--Various transitional positions over a period of up to 10 years--	
The most recent potential calibration of Solvency II (Quantitative Impact Study 5; QIS 5) introduces risk-based capital requirements for asset risk. Lighter risk weights on short-dated highly rated corporate bonds and high weights on equities, private equities and long-dated lowly rated corporate bonds.		

The New Regulations Will Tighten Corporate Funding Conditions

As these two regulatory frameworks are rolled out over the next few years, we anticipate corporate treasurers the world over will ask themselves two questions: Will I still have the same amount of funding available? And if so, under what conditions? The good news about Basel III is that, by substantially raising risk weights for market operations, regulators have made it more likely that banks would have a greater incentive to lend. Nonetheless, the combined impact of Basel III and Solvency II, although still uncertain in some respects, is likely to cause some profound shifts both in terms of pricing and risk-taking behavior by banks and insurers, in our view.

We consider the main effect of Basel III and Solvency II on creditor behavior and corporate funding access under static conditions as the following:

Lenders may be less likely to lend to market segments they perceive as too risky

The proposed regulatory framework motivates banks to lend to corporates relative to other activities perceived to be riskier, such as proprietary trading. Nevertheless, as was already the case for Basel II, capital requirements for banks increase commensurately as counterparty credit quality declines, which could increase pricing for the less creditworthy borrowers. Some banks and insurers may also rethink their commitment to lend to some market segments they perceive to be too risky from a risk-return perspective. For banks, Basel III has not added much in this respect compared with Basel II in our view, apart from counterparty risk in the trading book with the creation of a credit valuation adjustment (CVA) charge. Nevertheless, this would only affect large corporates on their trading operations.

Solvency II imposes capital requirements for asset risk, whereas currently no such requirements exist under Solvency I. Higher capital requirements will apply to higher yield portfolios and longer dated instruments, which may limit their appetite to lend to this important asset class.

Banks may increase their lending costs

Because banks will have to retain higher capital levels under Basel III, their profitability thresholds on lending margins will be higher. To assess the likely extent that this may increase borrowing costs for corporates, we ran two sets of simulations for investment grade, cross-over (that is mid 'BB' to mid 'BBB' credits on Standard & Poor's rating scale), and lower speculative-grade credits (that is, rated at 'BB-' and below), respectively. Our first simulation assesses solely the effect of increased capital requirements (see table 2). The second is augmented by a 100 bps charge to reflect the introduction of the net stable funding ratio (see table 3; for further details on the net stable funding ratio see Appendix I). Both tables show the incremental costs in basis points that the banks will need to pass on to their borrowers, if they want to maintain post-tax return on equity (ROE) targets of 8%, 10%, and 15%.

Table 2

Incremental Borrowing Costs Due To Increased Capital Requirements*			
(Bps)	--Return on equity threshold target--		
	8%	10%	15%
Investment grade	20	25	40
Mid 'BB' to mid 'BBB'	39	51	80
Speculative grade	70	91	142

Source: Standard & Poor's calculations. *Assumes regulatory risk weights of 35% of investment grade, 70% for 'BB' and 'BBB' categories, and 125% below; core Equity of 9.5%; Hybrid Tier 1 of 1%; funding costs over LIBOR of 30 bps for senior debt, 500 bps for Tier 1 and 0 bp on deposits; Loan to deposit ratio of 150%; and tax rate of 33%.

Table 3

Incremental Borrowing Costs Due To Increased Capital Requirements--Plus 100 Basis Points Liquidity Charge*			
(Bps)	--Return on equity threshold target--		
	8%	10%	15%
Investment grade	50	56	70
Mid 'BB' to mid 'BBB'	66	78	107
Speculative grade	92	112	164

Source: Standard & Poor's calculations. *Assumes regulatory risk weights of 35% of investment grade, 70% for 'BB' and 'BBB' categories, and 125% below; core Equity of 9.5%; Hybrid Tier 1 of 1%; funding costs over LIBOR of 30 bps for senior debt, 500 bps for Tier 1 and 0 bp on deposits; Loan to deposit ratio of 150%; and tax rate of 33%.

According to our calculations in table 3, incremental borrowing costs resulting from the increased capital requirements and liquidity charge could be between 50 bps and 70 bps for investment-grade issuers and between 92 and 164 bps for speculative-grade issuers. We should note that the purpose of these simulations is illustrative only, because various aspects of Basel III could still change and banks could also decide to lower their ROE targets. Nevertheless, we believe this represents fairly the general direction of the effect on borrowing costs.

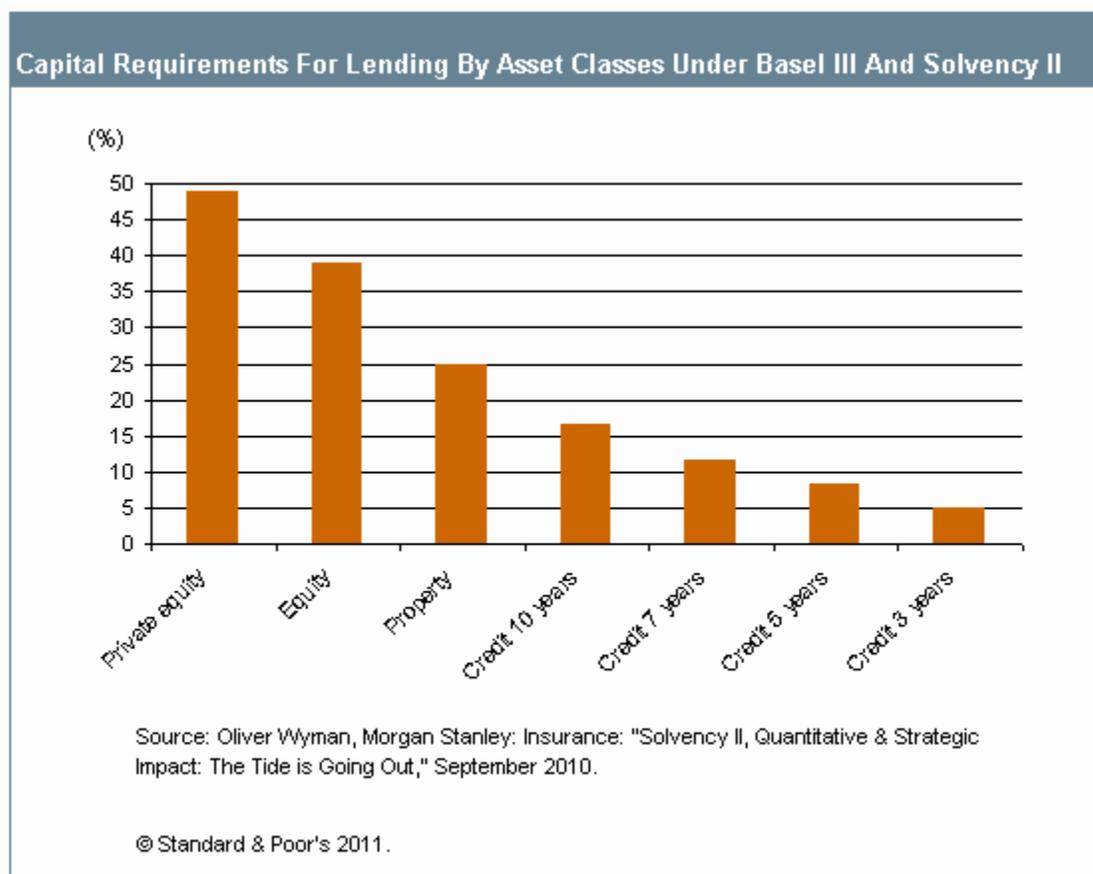
Banks and insurers are more likely to lend at shorter terms

Under the Solvency II and Basel III rules, insurers and banks would have to allocate less capital for shorter term credit transactions. This will increase lenders' incentive to lend shorter term, in our view. This is also the conclusion of an IMF Working Paper regarding the introduction of Solvency II (for further details see page 45 of the IMF working paper WP/11/187 "Possible Unintended Consequences Of Basel III And Solvency II," by Ahmed Al-Darwish, Michael Hafeman, Gregorio Impavido, Malcolm Kemp and Padraic O'Malley, August 2011.)

A joint study based on the EC's Fifth Quantitative Impact Study (QIS 5) by Oliver Wyman and Morgan Stanley shows that insurers may require three times as much capital to invest in a credit instrument with a 10-year term as they would for a three-year term (see chart 1). Given that insurance companies are key providers of long-term funding required by capital-intensive or infrastructure companies, we believe that such a development could significantly increase borrowing costs and potentially ration credit for these issuers.

Conversely, under the new net stable funding ratio, to be implemented in 2018, banks will have an incentive to issue more long-term funding--that is, resources with a maturity higher than one year. Banks will have to replace some short-term debt with longer term debt, which is more costly under normal market conditions. We believe this could lead to a crowding-out effect, with banks competing directly with large corporates at a time when the demand from investors--notably insurers--for such long-term securities could shrink. We envisage that this could encourage some corporates to compromise their capital structures by financing long-term assets with shorter term debt to save on funding costs. We consider that this would be an imprudent financial approach in terms of asset-liability risk matching.

Chart 1



Committed bank facilities may become pricier

Most corporate treasurers contract facilities with bank syndicates, be it as back-up for short-term commercial paper, working capital requirements, capital spending, or any other treasury purposes. Under Basel III rules, banks will have to assume that such general-purpose credit facilities are fully drawn, and will hence require higher capital requirements. In turn, they will probably require higher pricing to maintain the same profitability target. By contrast, the regulation assumes that dedicated credit facilities will be drawn down by only 10%. The implication may be that corporate treasurers will seek to replace general-purpose facilities with dedicated ones.

OTC derivatives will become more expensive

The CVA charge, to come into effect in 2013 under the Basel III framework, will increase regulatory capital requirements significantly for counterparty risk related to over-the-counter (OTC) derivatives transactions. We anticipate that banks will pass these higher capital requirements on to their clients for the pricing of their hedging solutions. In contrast, pricing on plain vanilla derivatives could decline again because separate regulations on hedging instruments force them to move to centralized clearing platforms.

Deposits from corporates may attract less favorable conditions than those of SMEs

Regulations imposed under the planned liquidity coverage ratio in Basel III to be implemented in 2015 could result in banks offering less attractive deposit terms to larger corporates than to small and midsize enterprises (SMEs), in

our view. This ratio aims to ensure that a bank has enough liquid assets to meet potential deposit outflows over a one-month horizon should a stress scenario materialize. The regulation assumes an outflow of 5% on SME deposits over a one-month horizon, compared with an outflow of 75% for large corporates. We believe this will make it more attractive to lend to SMEs, which maintain a high level of deposits on their accounts.

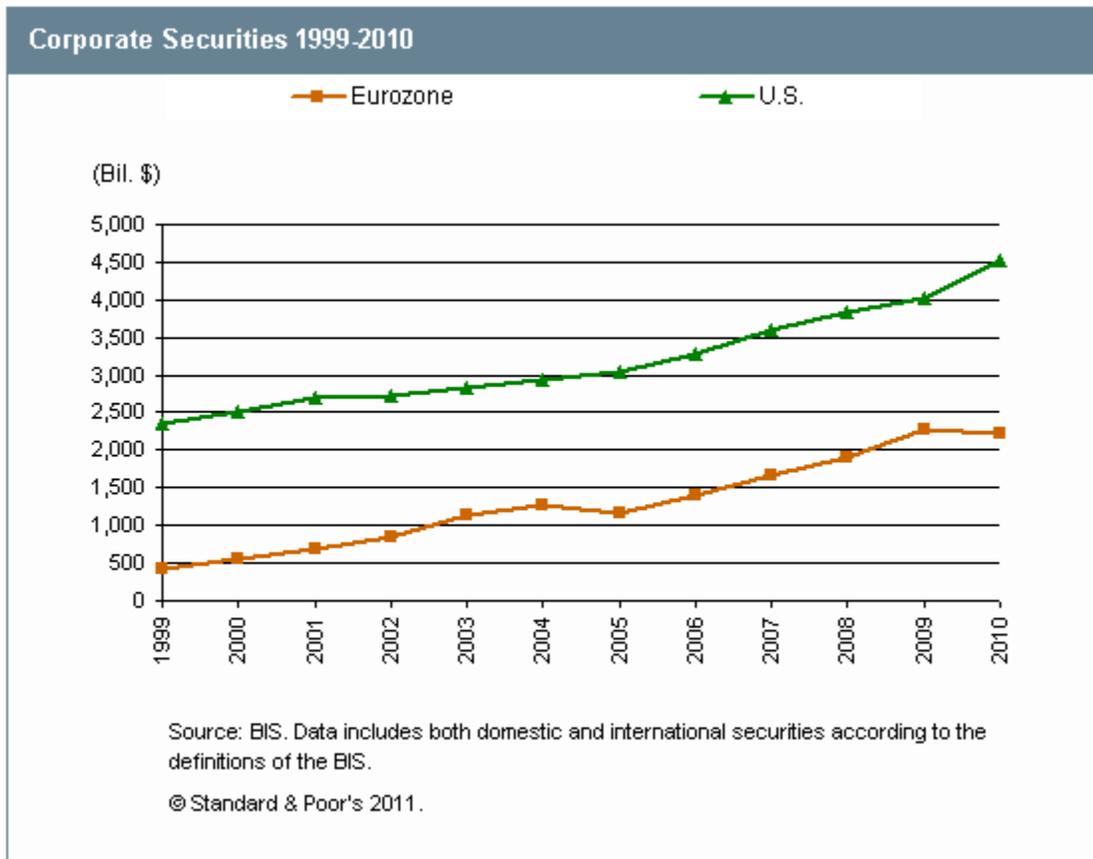
Equity and private equity will face the highest capital charges

Because capital charges related to equity and private equity holdings are introduced for the first time for insurers under Solvency II, we believe this could reduce their incentive to hold these asset classes. In our view, this could deprive banks--and corporates--of a much-needed investor base as they strive to raise regulatory capital levels. For the same reason, private equity groups may face a higher cost of funding on both debt and equity, which we believe could ration funding for this particular asset class.

European Corporates' Reliance On Bank Borrowing Exposes Them To Higher Risk

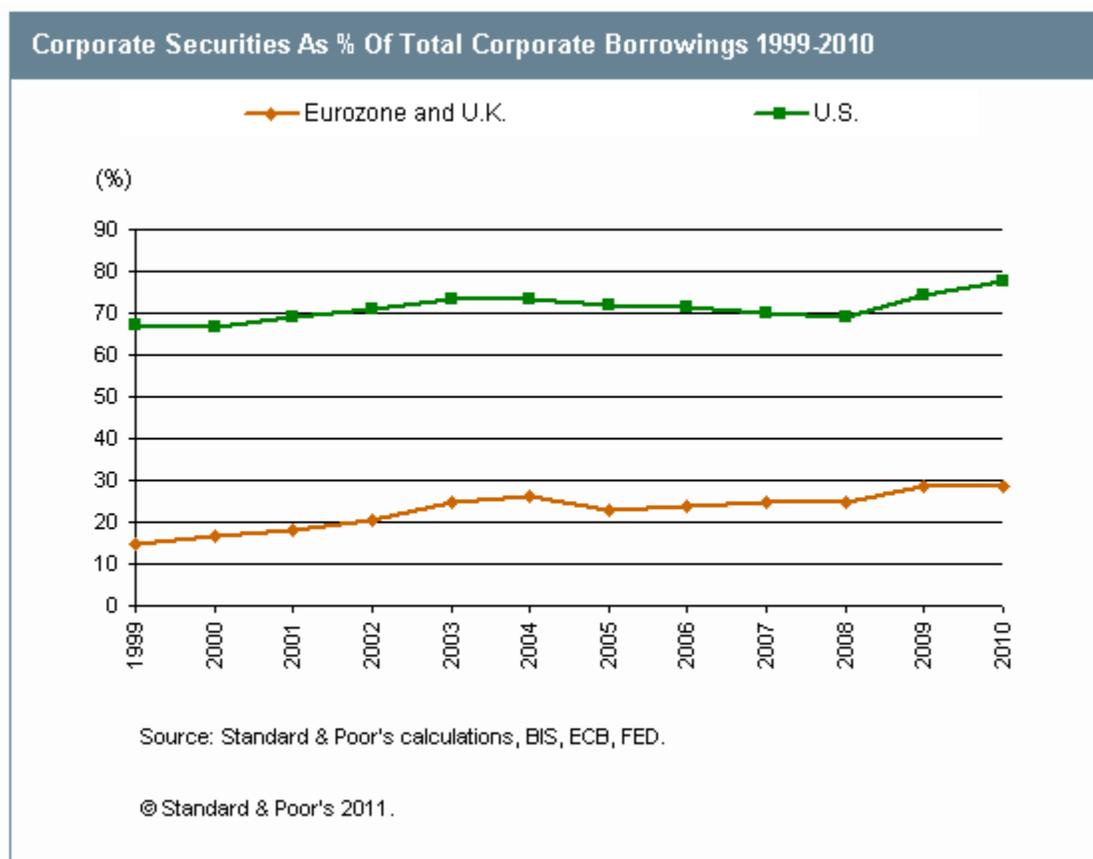
The creation of the euro has given rise to a very vibrant market for corporate securities, which has grown more than fourfold between 1999 and 2010. During the same period, the British pound-denominated corporate bond market grew more than threefold compared with a "meager" 90% for its U.S. dollar-denominated counterpart. Yet, while this growth appears encouraging, absolute figures paint a different picture: At €2.2 trillion, the corporate eurobond market was only about one-half the size of its U.S. equivalent of €4.5 trillion at the end of 2010. Given that U.S. GDP is only slightly higher than that of the eurozone, one would not expect a gap of such a magnitude (see chart 2).

Chart 2



In view of the small share of capital market funding relative to bank funding in Europe, banks clearly still continue to play a pre-eminent role in funding Europe Inc. (see chart 3). U.S. corporates, by contrast, rely almost exclusively on capital market sources for term-debt financing, with banks providing working capital and other short- to medium-term revolving credit facilities.

Chart 3



We see many reasons to explain this enduring difference. First, whereas the U.S. corporate bond market is at least 150 years old, dating back to the construction of the railways, the corporate eurobond market is barely 10 years old, even though most eurozone members had national bond markets. Second, the U.S. shares one legal and regulatory system, while the eurozone is still made up of 17 sovereign countries with many national commercial banks, and institutional and administrative convergence is only a recent development. Finally, while the U.S. has experienced high-profile bank failures in the past, prompting corporate treasurers to look for alternative sources of funding, European governments have traditionally tended to support their banks, even when these were essentially bankrupt.

While large, publicly traded companies in Europe have embraced the development of the euro and its converging capital markets with enthusiasm, privately held firms have generally continued to rely almost exclusively on banks for their funding, and may have borrowed at prices that did not truly reflect their risk, in our view. Since 2007, this relatively comfortable funding environment for corporates has changed dramatically as banks' own funding conditions have deteriorated sharply. We consider that the traditional underwrite-and-distribute syndicate model will be difficult to maintain in the future without loan pricing that is more reflective of risk.

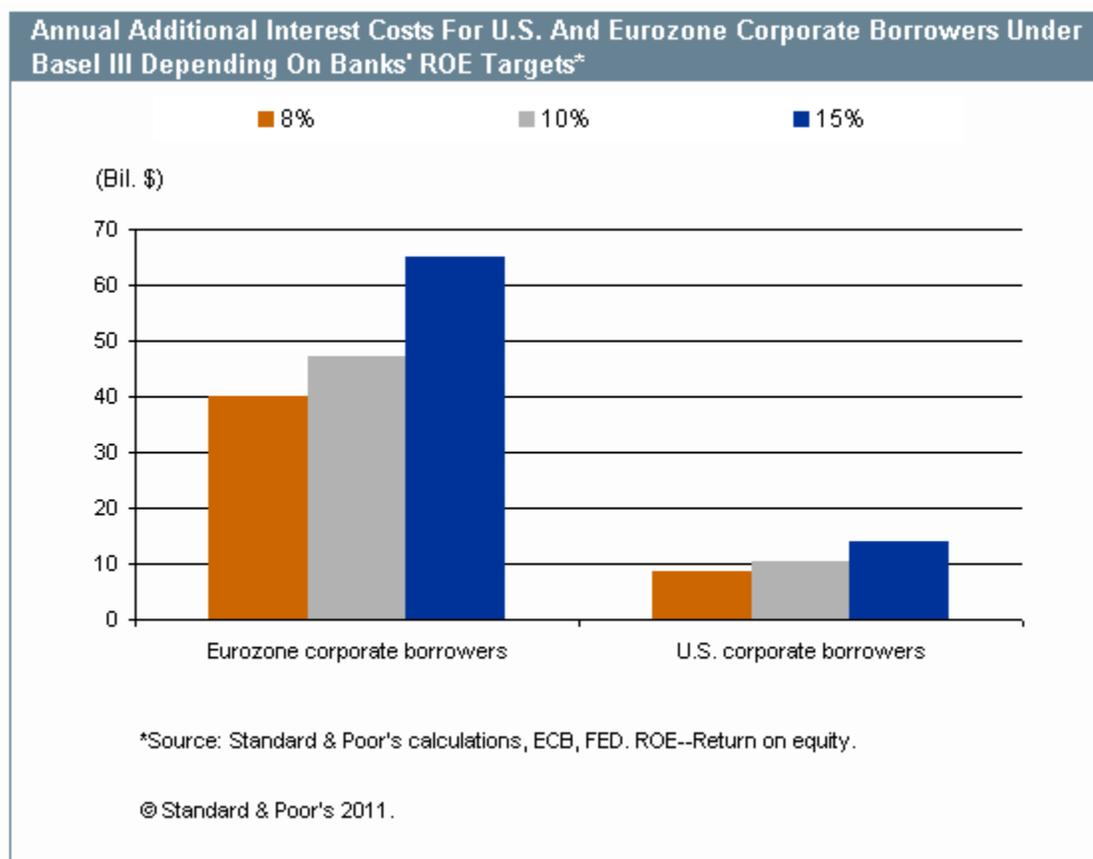
Certain banks will have to raise substantial amounts of capital to be Basel III-compliant. The Committee of European Banking Supervisors in December 2010 estimated that the largest European banks will have to raise about €260 billion externally or through increased earnings' retention. If they can't--and current equity market conditions

are less than conducive to capital-raising for banks--the stark alternative will be to deleverage to meet the new prudential standards. This, in turn, could lead to serious credit rationing in Europe, and hurt primarily firms with no access to the capital markets, in our view.

In such an event, we believe that in the near term some of the less diversified, highly leveraged corporate entities, or those firms that simply did not want to contend with public disclosure requirements in Europe, could find themselves scrambling for cash. In the longer term, however, we expect to see a narrowing of the almost \$2 trillion gap for corporate securities between the U.S. and Europe that persisted at the end of 2010 (see charts 2 and 3). We believe that corporates will increasingly turn to the capital markets as bank financing becomes more reflective of risk and terms and conditions more restrictive. As this shift takes place, we anticipate that asset managers will invest more directly in corporates and less in banks.

Nevertheless, if the heavy reliance on bank funding persists, European corporates could find themselves quickly at a competitive disadvantage relative to their U.S. peers, in our view. We have used our own findings (see tables 2 and 3) and data from the Bank for International Settlements and the central banks to assess the macro effect of the incremental borrowing costs for corporates. Assuming a 100 bps liquidity charge and an average credit quality of a bank lending portfolio in the 'BB' to 'BBB' range, which we view as a slightly generous assessment, the impact would be significant for eurozone borrowers. We anticipate that it could range between €30 billion and €50 billion annually. In contrast, the impact for U.S. borrowers would be more modest and range between \$9 billion and \$14 billion (see chart 4). This represents an increase of between 10% and 20% over current interest costs for corporate borrowers for Europe and the U.S., depending on banks' ROE targets of 8% to 15%).

Chart 4



Corporate Borrowers Face A Challenging Transition Phase

As a result of our analysis we consider that, while the introduction of the Basel III and Solvency II regulatory frameworks is likely to enhance the stability of global financial markets, also it may also cause some profound shifts in the European financial landscape, more so than in the U.S.

It will likely mean significantly higher borrowing costs for corporates as banks attempt to pass on the higher cost of capital to their clients. It will likely also reduce availability for funds with a longer tenor of seven years and above because they attract higher capital weights under both Basel III and Solvency II. It will also potentially lead to higher hedging costs and a reduced equity investor base.

We anticipate that the effect of these regulatory frameworks will be felt more acutely in Europe than in the U.S. because, for historical reasons, European corporate treasurers rely much more heavily on bank funding than their U.S. counterparts.

In spite of some isolated exceptions, we consider that the overall liquidity position of European rated corporates is currently adequate, based on our criteria, reflecting the significant refinancing that has taken place over the past two years. During that period, we have seen an increasing number of companies making maiden trips to the altar of the public bond markets to secure longer term funding from the capital markets at very favorable conditions. We believe

this should assist these entities to weather the prevailing difficult funding conditions.

When considering the future, it's tempting to make the mistake of projecting changes in a static environment. Capital markets have in the past shown their capacity to reinvent themselves with the emergence of new players and innovative sources of funding. In the current transition phase that could prove to be challenging for corporate borrowers, we believe such innovation may well influence the development of the capital markets.

Appendix: Basel III And Solvency II—A Primer

The main changes to bank regulation proposed in Basel III

The Basel III bank regulatory regime, agreed by the members of the Basel Committee on Banking Supervision, is the successor to Basel II, implemented at the start of the past decade. This, in turn, was the successor to the Basel Accords of 1988 on minimal capital requirements for banks, known as Basel I. By establishing tighter capital requirements and introducing liquidity, funding, and leverage guidelines, the most recent proposals in our view indirectly recognize the shortcomings of Basel II in these areas in light of the recent financial crisis.

The key regulatory changes, to be implemented in stages between 2013 and 2018, are as follows:

Increased capital requirements. These aim to provide a large enough buffer to absorb losses by banks during periods of stress, and increase the risk weights placed on market activities. The regulatory changes related to market risk capital requirements are better known as Basel 2.5 and will be implemented in January 2012, one year before the Basel III package. The Basel III regulations will raise minimum total capital requirements in a step-by-step process until 2018, at which time they should reach 10.5% from the current 8.0%. This includes the so-called capital conservation buffer, which creates constraints on banks' capital and shareholder distribution policies. The regulations impose further minimum capital requirements for systemically important financial institutions (SIFIs), with a capital surcharge of up to 350 basis points (bps). On top of this, the Basel Committee is discussing imposing a countercyclical capital buffer of up to 250 bps for all banks. It increases not only the quantity of capital, but also its quality, with minimum common equity more than doubling to 4.5% by 2015, including the capital conservation buffer, and to 7.0% by January 2019 from currently 2.0%. The new capital charges additionally aim to reflect counterparty credit risk (CCR) in light of the Lehman default and its aftermath. We anticipate that those most affected will likely be financial institutions with large derivatives and trading businesses.

New liquidity and funding ratios. By introducing these ratios in 2015 and 2018, respectively, banking supervisors aim to prevent run-offs on banks perceived to be vulnerable. The liquidity coverage ratio tests the stock of high quality liquid assets relative to net cash outflows over a stressed period of 30 days. The funding ratio--known as the net stable funding ratio (NSFR)--tests the amount of stable funding relative to the required amount of stable funding over a one-year period.

The introduction of a leverage ratio. As a supplementary measure, the leverage ratio should identify outlying banks relative to their peers and prevent institutions from subverting capital requirements. The ratio will measure high quality capital relative to a total exposure or asset measure.

The key changes to insurer regulation in Solvency II

The Solvency II EU directive that codifies and harmonizes the EU insurance regulation promises to transform the industry (see "Solvency II Implementation Looms, But European Insurers Still Face Uncertainty After Fifth Quantitative Impact Study," published April 6, 2011, on RatingsDirect on the Global Credit Portal). The predecessor regime, Solvency I, dates back over 30 years and generally is no longer regarded as fit for purpose. Per draft legislation, the effective date for Solvency II is January 2013, although it may be deferred by up to one year.

Furthermore, transitional measures over as much as 10 years will cushion the initial impact.

The implications for insurers are huge, in our view, and will have a significant bearing on insurers' investing activities, which currently attract no capital requirements at all, regardless of risk characteristics. Based on the fifth Quantitative Impact Study (QIS 5), the risk-based capital regime of Solvency II will introduce shorter dated and highly rated debt instruments over longer dated and lowly rated instruments. The European insurance industry currently holds investments valued at about €7 trillion, 40% of which are held in debt securities.

Solvency II consists of three pillars: quantitative requirements; qualitative requirements, including risk management; and disclosure requirements. Like Basel III for banks, the introduction of solvency and minimum capital requirements should in our opinion lead to increased regulatory consistency across jurisdictions--within the EU at least--particularly in the area of risk-based capital adequacy relative to economic risk.

Introduction of a solvency capital requirement (SCR). The centerpiece of the first pillar of Solvency II is the introduction of a Solvency Capital Requirement (SCR). It aims to provide a standard measure for market, underwriting, and non-insurance risks, as well as counterparty default risks. The measure reflects the aggregate impact of stresses reflecting these risks, focusing on a market-consistent value of the assets and liabilities. Insurers that breach the SCR would not face automatic regulatory intervention, but will require management to submit to the regulator a plan demonstrating how it will rectify the breach.

Introduction of a minimum capital requirement (MCR). The regulation also introduces a minimum capital requirement (MCR), which should be an absolute minimum level of capital, a breach of which would result in ultimate regulatory intervention. Market participants expect that the corridor for the MCR will range between 25% and 45% of the SCR.

Related Criteria And Research

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