S&P Global Ratings

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Summary:

Iceland

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Table Of Contents

Key Rating Factors

Outlook

Rationale

Key Statistics

Ratings Score Snapshot

Related Criteria

Related Research

Summary:

Iceland

Issuer Credit Rating	A/Stable/A-1

Key Rating Factors

Institutional and economic profile	Flexibility and performance profile
Growth is set to resume in 2020, although at lower rates than in the years before 2019. • Iceland experienced a negative shock to its tourism sector this year, but the economic repercussions appear less severe than previously anticipated. • We project real GDP will decline only marginally in 2019 and return to growth from next year. • We project the unemployment rate will rise above 4% from the previous historically low levels.	Iceland's external and fiscal buffers remain sound. • Iceland's current account will remain in surplus until 2021 but will gradually erode. • Net general government debt has reduced to below 30% of GDP, creating fiscal space as we expect moderate deficits in 2019-2022. • We continue to view monetary policy as constrained by the small Icelandic economy's susceptibility to external developments.

Outlook

The stable outlook balances Iceland's strong fiscal and external buffers against risks stemming from the inherent volatility of Iceland's small open economy and a potentially stronger-than-expected slowdown in tourism.

We could raise the ratings on Iceland if its fiscal performance and external position significantly strengthen beyond our current projections over the next two years.

We could lower the ratings on Iceland if we observed signs of increasing balance of payments pressures or risks to the stability of the financial sector over the next two years. These could emerge if this year's reduction in tourism flows had greater economic impact than expected, putting pressure on the balance of payments and the financial system, including the lending activities of pension funds via an impact on the housing market.

Rationale

The ratings on Iceland reflect the country's very high GDP per capita in a global comparison, its stable institutional framework, and effective policymaking. Despite Iceland's net external creditor position, our ratings are constrained by the country's susceptibility to external shocks and the structural volatility of its economy. The ratings also take into

account Iceland's sound fiscal position following the sizable reduction in government debt in recent years and the country's structurally constrained monetary policy flexibility.

Institutional and economic profile: Growth will pick up again after the shock to the tourism sector in 2019

The Icelandic economy remains small in absolute terms (with a population of about 360,000 and GDP of $26 billion) and ultimately susceptible to developments in terms of trade, given its concentration in the tourism, marine, and metals (aluminum) sectors. This year's supply shock to the tourism industry underpins our view of its inherent volatility. The decline in tourism flows has been aggravated by the failed capelin fishing season.

After a decade of rapid growth, with visitor numbers increasing fivefold since 2010, the tourism sector now directly accounts for about 9% of Iceland's GDP. Following WOW Air's bankruptcy, flight supply remains a key concern in the short term as Icelandair's capacity expansion plans were relying heavily on the Boeing 737-Max aircraft type, which remains grounded globally on safety concerns. We note that available data indicates that tourist arrivals have declined by more than 10% so far in 2019.

Nevertheless, we now project the Icelandic economy will contract by only a moderate 0.3% in 2019, a sizable upward revision compared with our spring forecast of a more pronounced recession.

The improved economic outlook compared with the beginning of the year reflects several factors:

- As expected, tourist numbers have declined by more than 10% annually, driven by the bankruptcy of Iceland's second-largest airline, WOW Air, in March 2019. But the national carrier Icelandair was able to adjust its passenger mix, carrying fewer transit passengers and more tourists. At the same time, tourists stayed longer and spent more in Iceland.
- Imports declined more than exports in the first half of 2019, not only investment goods but also durable goods.
- The conclusion of the private sector wage agreements in April 2019 lifted uncertainty for businesses. The agreements provided relatively moderate wage increases--taking into account the weaker macroeconomic environment--thereby alleviating fears of a wage inflation spiral.

We expect real GDP to expand by 1.8% in 2020, as the economy recovers from a light recession helped by robust public consumption. With a challenging external environment as well as somewhat weaker domestic demand, we expect similar growth rates over the medium term. This represents a slowdown compared with the rapid pace of economic expansion Iceland has experienced in recent years.

We also expect an increase in the unemployment rate to above 4% from the previous historically low levels. This increase is driven by job losses in the tourism sector. Importantly, the new wage agreements, covering almost the whole private labor market, alleviate concerns regarding an overshooting of the real effective exchange rate, which resulted from prior examples of collective bargaining in Iceland. We believe that the wage agreements and accompanying government measures could retrench Iceland's tradition of ensuring a high degree of social equality and inclusion.

We continue to view Iceland's institutional arrangements as a key rating strength. There are broadly functioning checks and balances between various state bodies and consensus on key issues, such as the need to maintain a

comparatively prudent fiscal position. Iceland's coalition government following the October 2017 snap elections comprises three parties spanning the left and right of the political spectrum.

Flexibility and performance profile: Fiscal and external buffers should help navigate a challenging environment

We project Iceland will post a small budget deficit in 2019, down from a surplus of about 1% of GDP in 2018. Further ahead, we forecast contained deficits of 1.5% on average in 2020-2022. This is weaker than the government's own revised target of balanced budgets over the medium term. We think that the weaker growth outlook, rising unemployment, and fiscal measures agreed around the wage negotiations will increase fiscal pressures. At the same time, some loosening of tax policy and infrastructure investments will continue.

At the same time, we consider that Iceland has fiscal headroom, allowing for some deterioration in budgetary performance. Iceland has restored fiscal buffers by reducing its government debt burden markedly over the past few years, and net general government debt is now below 30% of GDP. We expect net government debt will be about 28% of GDP in 2019-2022. This compares with a peak of almost 80% of GDP in 2011, and underlines Iceland's rapid deleveraging after the 2008 financial crisis. We currently do not factor any additional proceeds from the sale of commercial banks into our projections, but anticipate that government ownership in the sector could decline over the coming years, potentially generating extra one-time revenue.

We continue to see some moderate risks from contingent fiscal liabilities, particularly from the decreasing, albeit still-high stock of government guarantees to public-sector entities, such as the Housing Financing Fund (HFF) or energy company Landsvirkjun. HFF's liabilities will continue to reduce as it has ceased new lending activities. The legislative process is currently ongoing to split HFF and create a new government agency, which will receive HFF's social loans portfolio while the HFF fund will maintain the ownership of the rest of the balance sheet in run-off and it will not grant new loans. The HFF fund would then be ultimately managed by the Ministry of Finance.

The Icelandic krona exchange rate has remained relatively stable in recent months, despite the weakening economic outlook. However, it has depreciated by roughly 10% (narrow trade index) since the beginning of 2018. This could help improve price competitiveness, which suffered in recent years when the krona appreciated significantly as the balance of payments strengthened.

The reduction of imports has this year prevented a stronger tourism-driven deterioration of the current account balance. We project that Iceland's current account surplus will decline over the coming years and swing to a small deficit by the end of our forecast horizon in 2022. This follows years of high surpluses thanks to the growth of the tourism sector, which propelled Iceland's external position to being a net external creditor. We project our preferred measure of narrow net external debt to rise to 55% of current account receipts by 2022 from below 40% in 2018. We continue to anticipate a pickup in investment abroad by the Icelandic pension funds because they are diversifying their investments after capital controls were lifted in early 2017. The special reserve requirement on inflows of foreign currency was lowered to 0% in March 2019, from 20% previously, which could further spur flows into Iceland's domestic bond market.

We continue to view Iceland's monetary policy effectiveness as constrained by the structural features of the Icelandic economy, given its small size and the inflation level's pronounced dependence on the value of the exchange rate and

foreign prices. We also note that Iceland's real effective exchange rate tends to be particularly volatile over the economic cycle, and subject to large valuation swings that have historically exacerbated the cyclicality already inherent in Iceland's economy.

The central bank has embarked on a series of interest rate cuts in the course of 2019. This monetary policy reaction was facilitated by relatively contained inflation thus far in 2019, with consumer price index inflation of 2.8% in October, despite the depreciating krona. We expect inflation to average 3% in 2020-2022, broadly in line with the central bank's 2.5% target. That said, this contained level of inflation will to a large degree remain a function of a more stable exchange rate and muted inflation in Iceland's key trading partners rather than specific policy measures by the central bank.

Positively, we consider that Iceland's monetary flexibility has somewhat improved in recent years, particularly following the March 2017 lifting of capital controls and given the adherence to a broadly flexible exchange rate arrangement since then. We also believe that the accumulation of substantial extra net foreign exchange reserves has underpinned the Central Bank of Iceland's improved ability to act as a lender of last resort for the domestic banking system both in foreign and local currencies.

The intergovernmental body Financial Action Task Force (FATF) announced on Oct. 18, 2019, that it had added Iceland to its so-called "grey" list of monitored jurisdictions. The FATF identifies jurisdictions with weak measures to combat money laundering and terrorist financing. We do not expect a material impact on the financial status or reputations of Icelandic banks, since the authorities will likely execute pending legislative improvements swiftly.

We understand that Iceland has made progress in multiple areas to strengthen its anti-money laundering and financial crime framework following FATF initial evaluation in February 2018 (see "Bulletin: Banking Industry Country Risk Assessment For Iceland Unaffected By The Country's FATF Grey Listing," published Oct. 23, 2019, on RatingsDirect). The remaining issues in FATF's assessment do not relate directly to the financial system and include: The timely registration of beneficial ownership; full implementation of an automated system to register and file suspicious transactions; allocation of adequate resources and staff to the financial intelligence unit; and effective monitoring of non-profit organizations.

According to the Icelandic government, flagged issues have already been, or will be, addressed in the coming months. The next FATF review and the outcome will be announced next year.

Our Banking Industry Country Risk Assessment (BICRA) still places Iceland's banking sector in group '4'. We still see a negative industry risk trend, primarily because of the sector's low overall profitability (see "Four Icelandic Banks Outlooks Revised To Negative On Weaker Business Prospects And Earnings; Ratings Affirmed," published July 23, 2019). The banks went through an economic recession in 2019, declining interest rates, still-high taxation, and stiff competition from pension fund lending in an industry that is concentrated, given the size of the economy and bankable population. The declining profitability of many banks illustrates these challenges.

The banks are more resilient having absorbed the shocks created by the 2008 financial crisis, with low nonperforming assets, stabilizing private sector debt, and the successful release of capital controls. Since 2017, growth in housing prices has cooled, following the slowdown in tourism and an increasing housing supply, which eased the risk of

overheating. At the moment, a large number of housing units are approaching completion and will add to housing supply. However, we consider that the banking sector might face incremental credit risks related to commercial real estate and tourism-related activities exposures.

Key Statistics

Table 1

Iceland Selected Indicators										
(Mil. ISK)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Economic indicators (%)										
Nominal GDP (bil. LC)	1,959	2,074	2,294	2,491	2,613	2,812	2,888	3,012	3,163	3,321
Nominal GDP (bil. $)	16	18	17	21	24	26	24	24	24	25
GDP per capita (000s $)	49.8	54.5	52.8	62.0	72.3	74.5	67.0	65.2	65.1	66.4
Real GDP growth	4.1	2.1	4.7	6.6	4.4	4.8	(0.3)	1.8	2.3	2.4
Real GDP per capita growth	3.4	0.9	3.7	5.5	2.6	1.8	(2.7)	0.3	0.8	0.9
Real investment growth	2.2	15.9	21.3	17.8	10.2	4.0	(4)	3.1	4.0	3.7
Investment/GDP	15.4	17.3	19.6	21.2	21.9	22.7	22.3	23.2	24.1	24.9
Savings/GDP	23.2	23.0	25.5	28.8	25.7	25.5	23.8	23.6	24.1	24.8
Exports/GDP	53.5	51.5	51.8	47.6	46.2	47.1	44.4	44.7	45.2	45.8
Real exports growth	6.7	3.2	9.1	10.9	5.4	1.7	(5.9)	2.0	3.0	3.5
Unemployment rate	5.4	5.0	4.0	3.0	2.8	2.7	4.2	4.3	3.7	3.5
External indicators (%)										
Current account balance/GDP	7.8	5.7	6.0	7.6	3.8	2.8	1.5	0.4	0.0	(0.1)
Current account balance/CARs	13.2	10.1	10.6	14.1	7.5	5.6	3.2	0.9	0.1	(0.3)
CARs/GDP	59.5	56.4	56.4	53.6	50.2	50.5	47.9	48.4	49.0	49.7
Trade balance/GDP	0.4	(0.5)	(1.5)	(4.1)	(6.3)	(5.8)	(5.9)	(6.6)	(7.0)	(7.2)
Net FDI/GDP	(0.3)	4.1	4.0	3.5	0.7	(1.8)	1.8	2.1	2.5	2.5
Net portfolio equity inflow/GDP	(0.0)	(0.2)	(2.3)	(5.7)	(1.6)	(1.3)	(2)	(3.9)	(3.9)	(3.8)
Gross external financing needs/CARs plus usable reserves	96.6	99.8	93.4	90.4	80.4	85.2	85.7	89.1	91.7	93.8
Narrow net external debt/CARs	71.1	58.3	143.4	55.7	50.7	38.0	45.2	51.1	53.9	55.4
Narrow net external debt/CAPs	81.8	64.8	160.4	64.9	54.9	40.2	46.7	51.6	53.9	55.2
Net external liabilities/CARs	19.3	8.9	9.8	(5.7)	(7.2)	(21.5)	(27.5)	(28.1)	(27.2)	(25.5)
Net external liabilities/CAPs	22.2	9.9	11.0	(6.7)	(7.8)	(22.7)	(28.4)	(28.4)	(27.2)	(25.5)
Short-term external debt by remaining maturity/CARs	50.3	50.0	41.9	44.5	35.3	33.5	36.1	40.6	40.7	39.4
Usable reserves/CAPs (months)	5.8	5.4	5.5	6.2	7.6	6.4	6.8	6.9	6.4	5.8
Usable reserves (mil. $)	4,017	3,988	4,895	7,231	6,575	6,328	6,495	6,259	6,020	5,772
Fiscal indicators (general government; %)										
Balance/GDP	(1.8)	(0.1)	(0.8)	(3.0)	0.5	0.8	(0.1)	(1.5)	(1.5)	(1.3)

Table 1

Iceland Selected Indicators (cont.)										
(Mil. ISK)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Change in net debt/GDP	1.3	(7.3)	(2.9)	(3.6)	(1.8)	(5.7)	0.4	1.7	1.6	1.3
Primary balance/GDP	2.6	4.5	3.6	1.0	4.4	3.7	2.3	1.0	1.0	1.2
Revenue/GDP	40.6	43.7	40.6	41.5	43.6	42.8	42.6	42.8	42.9	42.9
Expenditures/GDP	42.4	43.8	41.4	44.5	43.0	42.0	42.7	44.3	44.4	44.2
Interest/revenues	10.9	10.4	10.9	9.5	8.9	6.6	5.7	5.8	5.8	5.8
Debt/GDP	88.0	80.9	65.0	51.2	43.3	35.9	37.1	37.3	37.1	36.6
Debt/revenues	216.8	184.9	160.2	123.4	99.4	83.9	87.1	87.1	86.5	85.4
Net debt/GDP	65.3	54.4	46.3	39.1	35.5	27.3	27.0	27.5	27.8	27.8
Liquid assets/GDP	22.7	26.5	18.7	12.2	7.8	8.6	10.2	9.7	9.3	8.8
Monetary indicators (%)										
CPI growth	3.9	2.0	1.6	1.7	1.8	2.7	3.1	3.0	3.0	3.0
GDP deflator growth	2.1	3.7	5.6	1.8	0.5	2.7	3.0	2.4	2.7	2.6
Exchange rate, year-end (LC/$)	115.55	126.90	129.59	112.82	104.42	116.33	125.00	130.00	134.00	134.00
Banks' claims on resident non-gov't sector growth	(4.3)	(3.3)	(0.3)	1.7	6.8	9.1	6.5	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	167.1	152.6	137.6	128.8	131.1	132.9	137.8	138.8	138.7	138.7
Foreign currency share of claims by banks on residents	N/A	9.8	9.4	8.9	9.7	10.4	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	18.5	18.0	16.5	8.6	9.7	12.2	N/A	N/A	N/A	N/A
Real effective exchange rate growth	4.2	6.9	2.5	12.5	12.0	(2.6)	N/A	N/A	N/A	N/A

Sources: Statistics Iceland (Economic Indicators), Central Bank of Iceland, The Government of Iceland External Indicators), Statistics Iceland, Central Bank of Iceland (Fiscal Indicators), and Central Bank of Iceland, International Monetary Fund (Monetary Indicators).
Adjustments: Government debt adjusted by including loans from Norges bank and International Monetary Fund.
Definitions: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. ISK--Icelandic krona. N/A--Not applicable. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. e--Estimate. f--Forecast. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Iceland Ratings Score Snapshot		
Key rating factors	**Score**	**Explanation**
Institutional assessment	2	Generally strong, but relatively shorter track record of policies that deliver sustainable public finances and consistently balanced economic growth over the long term. Generally effective checks and balances and free flow of information through society. Statistical information is generally timely and reliable.
Economic assessment	2	Based on GDP per capita ($) as per the Selected Indicators table above.

Table 2

Iceland Ratings Score Snapshot (cont.)		
Key rating factors	**Score**	**Explanation**
		The economy is concentrated in fishing, aluminum, and tourism. The metals and fishing sectors together account for over 20% of GDP and are subject to volatility due to changing aluminum prices and varying fishing catch levels. The tourism industry also accounts for well over 20% of GDP including direct and indirect effects.
External assessment	4	Based on narrow net external debt and gross external financing needs as per Selected Indicators in Table 1.
		The country is exposed to significant volatility in terms of trade, due to its dependence on tourism exports and changes in metal prices.
Fiscal assessment: flexibility and performance	2	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1.
Fiscal assessment: debt burden	3	Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators in Table 1.
		Contingent liabilities are moderate. We assess the amount of guarantees provided by Iceland (implicitly and explicitly) to various non-deposit-taking institutions at over 30% of GDP. We believe there is a significant likelihood of extraordinary government support.
Monetary assessment	4	The krona is largely floating following the removal of capital controls, albeit with a shorter track record. The central bank has broad operational independence and uses market-based monetary instruments. Given the removal of capital controls and accumulation of extra net foreign exchange reserves, the central bank has the ability to act as lender of last resort for the financial system. However, Iceland exhibits a very volatile REER over the economic cycle.
Indicative rating	a+	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	-1	Some of the improvements over the past years have been cyclical improvements and we now see a reversal given the weaker macroeconomic situation. The economy is particularly volatile and susceptible to external shocks. This was evidenced by the effects of the WOW Air bankruptcy on the tourism sector. This is not fully captured in the indicative rating.
Foreign currency	A	
Notches of uplift	0	Default risks do not apply differently to foreign- and local-currency debt.
Local currency	A	

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology. REER--Real effective exchange rate.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings Score Snapshot, Nov. 5, 2019

- Banking Industry Country Risk Assessment Update: October 2019, Oct. 29, 2019
- Bulletin: Banking Industry Country Risk Assessment For Iceland Unaffected By The Country's FATF Grey Listing, Oct. 23, 2019
- Sovereign Ratings History, Oct. 10, 2019
- Sovereign Ratings List, Oct. 10, 2019
- Sovereign Risk Indicators, Oct. 10, 2019. An interactive version is also available at http://www.spratings.com/sri
- European Developed Sovereign Rating Trends Midyear 2019, July 25, 2019
- Default, Transition, and Recovery: 2018 Annual Sovereign Default And Rating Transition Study, March 15, 2019
- Sovereign Debt 2019: Global Borrowing TO Increase By 3.2% To US$7.8 Trillion, Feb. 21, 2019

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